It's Time

WPC Committee to review the
of securities regulation in

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It's Time

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WPC Committee to review the structure of securities regulation in Canada

CPA Comité pour examiner la structure de la réglementation des valeurs mobilières au Canada

December 17, 2003

Minister of Finance
Government of Canada
Ottawa, Ontario
K1A 0G5

Dear Minister:

On behalf of the Wise Persons' Committee to Review the Structure of Securities Regulation in Canada, I am pleased to present our recommendation for the best securities regulatory structure for Canada's capital markets.

This report reflects our unanimous view that Canada must adopt a fundamentally new structure – a single regulator administering a single code. This structure would be cooperatively created and overseen by the federal and provincial governments.

Our recommendation is based on extensive input from capital market participants, independent research studies, and the collective experience and judgment of our Committee.

There is a new and unprecedented consensus for change. This was made abundantly clear to us in 92 written submissions and nine days of public consultations across Canada. During these consultations, we heard from investors, issuers, financial intermediaries, industry associations, regulators and others interested in improving the efficiency and effectiveness of the Canadian securities regulatory system.

There is also a new and unprecedented need for change. Canada's regulatory structure is out of step with the needs of its capital market participants and it is out of step with the rest of the world.

Reform of Canada's securities regulatory structure and the development of a capital markets strategy are issues of fundamental importance for every Canadian.

Sincerely,

Michael E. J. Phelps
Chair

Harold H. MacKay
Vice Chair

Thomas I. A. Allen

Pierre Brunet

Wendy K. Dobson

Edwin C. Harris

Michael J. Tims

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EXECUTIVE summary

Executive Summary

It's time for Canada to have a single securities regulator.

There was a time when Canadian businesses seeking to raise capital were primarily located in the same region as the investors who bought their securities. In those days, Canada was well served by a provincially based regulatory structure.

Those days are gone.

Driven by the appearance of new technologies, deregulation, declining trade barriers and the emergence of new competitors and new financial products, capital markets that were once local are now national and international.

Other countries have responded to these fundamental changes by reforming their regulatory structures to improve their international competitiveness. Canada must keep pace with these changes.

Today Canada is the only major industrialized country without a national securities regulator.

Reform of Canada's securities regulatory structure and the development of a national capital markets strategy are issues of fundamental importance for every Canadian. Almost all Canadians today are investors in the equity markets, either directly or through mutual and pension fund holdings. Capital markets underpin investment, support job creation and lead to higher standards of living. Fair and vibrant capital markets are vital for Canada to reach its full economic potential.

The attractiveness of Canada's capital markets, at home and abroad, depends in no small measure on the quality of its securities regulation. Canada's securities regulatory architecture must change so that our capital markets become a source of comparative advantage.

The Current System Must Change

Canada's existing system of 13 provincial and territorial regulators is not without positive attributes. Its main strengths are the proximity of regulators to capital market participants in each jurisdiction and the development of expertise in specific industry sectors. Other strengths include its responsiveness to what are often characterized as local and regional issues.

EXECUTIVE

None of these strengths, however, is unique to the current system. Each can be preserved in alternative regulatory structures. More importantly, these strengths are significantly outweighed by serious weaknesses that must be promptly addressed.

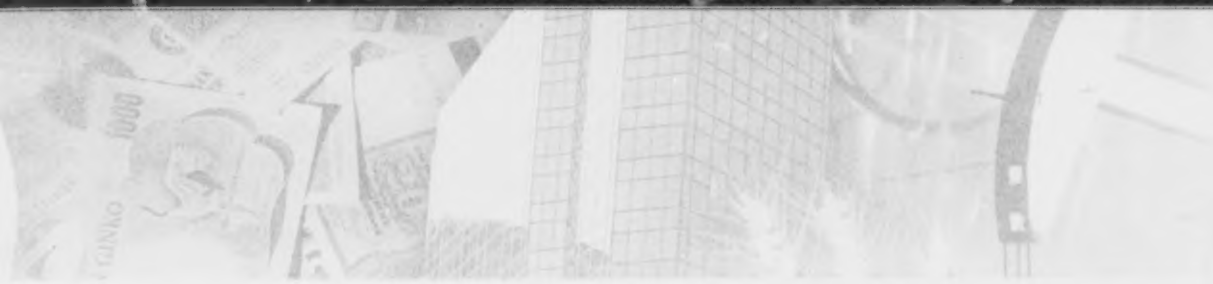
Canada suffers from inadequate enforcement and inconsistent investor protection. Policy development is characterized by compromise and delay. Canada cannot respond as effectively or innovate as quickly as it should in the fast-changing global marketplace. The system is too costly, duplicative and inefficient. The regulatory burden impedes capital formation. Canada's international competitiveness is undermined by regulatory complexity.

The Call for Change in Canada

Capital market participants, regulators and governments agree that Canada's securities regulatory structure is outdated and must change. The only real question is the nature and extent of the change.

Some provincial governments and securities regulators have proposed an incremental change – a "passport system" that would leave the existing infrastructure of 13 regulators intact, but in which capital market participants would generally be subject to and need only comply with the rules and decisions of a single jurisdiction, regardless of where they undertake capital markets activity in Canada.

A substantial majority of capital market participants, however, are of a distinctly different view. They are demanding a fundamental change – the creation of a single securities regulator. The Committee agrees.



A Securities Commission for Canada

We believe the choice is clear. Canada's system of securities regulation is in need of fundamental reform. Canada needs a single regulator in which both the federal and provincial governments have significant roles.

We recommend a structure in which:

- The federal government enacts a new Canadian Securities Act that provides a comprehensive scheme of capital markets regulation for Canada.
- The legislation takes into account the Uniform Securities Legislation Project that has been undertaken by the Canadian Securities Administrators, and other provincial legislative reform proposals.
- Amendments to the legislation would not be implemented if a majority of the provinces representing a majority of the population of Canada objected.
- The Canadian Securities Act is administered by a single Canadian Securities Commission consisting of nine full-time, regionally representative Commissioners.
- The Commission includes two Commissioners from each of Ontario and Quebec, one Commissioner from each of British Columbia and Alberta, and two Commissioners from the remaining provinces and territories. There would be no regional restriction on the ninth Commissioner.
- Commissioners are appointed by the federal Minister of Finance from nominees proposed by a Nominating Committee consisting of ten members designated by the provinces (one from each) and three members (representing investors, registrants and issuers respectively) designated by the Minister of Finance.
- The mandate of the Commission reflects the need to foster fair and efficient capital markets, the importance of regulatory innovation, and the unique characteristics of Canadian capital markets.
- A Securities Policy Ministerial Committee consisting of the ministers responsible for securities regulation in each province and the federal Minister of Finance is established to provide a forum for policy and administrative input.
- The Commission is responsive to the needs of Canada's capital markets, makes the best use of existing expertise, and has excellent on-the-ground service delivery where:
  - The Commission's head office, located in the National Capital Region, is responsible for policy development, the coordination of regional and district office activity, dealings with other Canadian financial sector regulators and international matters.
  - Strong, functionally empowered regional offices in Vancouver, Calgary, Winnipeg, Toronto, Montreal and Halifax review prospectuses and registration applications, grant exemptions, conduct compliance reviews and investigations and initiate enforcement proceedings, as well as contribute to policy development. Where necessary, there will be additional district offices to ensure effective and consistent issuer and investor treatment across Canada.
  - Capital markets advisory committees representative of large and small issuers and investors, as well as the regions, are established to provide knowledgeable stakeholder input to the Commission.
- Mechanisms, including guaranteed service levels at both the national and regional level, are established to ensure accountability to the Canadian public and to capital market participants.
- Adjudication is the responsibility of a separate body independent of the Commission.

We make this recommendation after giving careful consideration to the passport system. Although a significant incremental improvement over the current system, the passport system is not the best securities regulatory structure for Canada.

The passport system's strengths are single regulator contact, local presence and relative ease of implementation. Despite these strengths, each of which is included in the recommended model, the passport system contains significant weaknesses. It does not constitute a sufficient improvement in enforcement. Policy development would continue to suffer from the need to forge a consensus among multiple regulators with differing priorities and approaches. It would do little to enhance Canada's international capital markets credibility. Needless duplication would continue to exist as the passport system would maintain the current multiplicity of regulators. Issuers would continue to pay fees in all jurisdictions even though only one would serve as the primary regulator. Finally, the passport system does not, by itself, improve accountability or governance.

Why Canada Needs a Single Regulator

The Canadian Securities Commission model best achieves the objectives of an ideal securities regulatory structure. It preserves the strengths of our legacy structure while addressing its weaknesses in a manner that is superior to the passport system.

The recommended model:

- Significantly strengthens enforcement through more efficient allocation of resources, better coordination, the ability to set consistent enforcement standards and priorities, and uniform investor protection across Canada;
- Facilitates better and, when needed, more timely policy innovation and development;
- Addresses the disproportionate regulatory burden the current system places on small and emerging companies;
- Enhances the "brand" of Canada's securities regulation internationally;
- Eliminates additional compliance and opportunity costs resulting from multiple regulators;
- Ensures responsiveness to local and regional needs through the participation of the provinces and capital market participants in its governance structure and regional offices;
- Provides stability, since no jurisdiction could opt out of the system;
- Provides equal access to investment opportunities to all Canadians, regardless of the province or territory in which they live;
- Establishes clear accountability and governance mechanisms; and
- Simplifies the current system by reducing the number of regulators from 13 to one.

It's Time

The world has changed. Capital markets have changed. Canada must change.

The best regulatory structure for Canada and its capital markets is the single regulator model we have recommended, with a collaborative federal-provincial architecture.

On this point, we note that the history of provincial regulation has led to a misconception that the federal government lacks jurisdiction in respect of capital markets. This is not the case. Constitutional opinions provided to the Committee have confirmed that the federal government has the constitutional authority to pass comprehensive legislation regulating all capital markets activity within Canada.

We recommend that the federal and provincial governments implement our recommendation without delay. Canadians are seeking increased federal-provincial cooperation in addressing important public policy priorities. This is a vitally important issue for Canada and it provides an opportunity for both levels of government to come together and act in the national interest.

If, however, not all the provinces decide to participate in establishing the Canadian Securities Commission, we recommend that the federal government nevertheless proceed with the implementation of our recommendation so that Canada will have only one securities regulator. While provincial cooperation would surely be preferable, it is not necessary. The constitutional opinions presented to the Committee confirm this conclusion.

There is a remarkable momentum for change driven by a strong consensus among capital market participants. There is also an unprecedented opportunity to improve Canada's securities regulatory structure and enhance its international competitiveness.

It's time to act.

CHAPTER one

Why Change? Why Now?

Our present securities regulatory structure served Canada adequately in the past, but we need the best possible structure for Canada's future.

There was a time when Canadian businesses seeking to raise capital were primarily located in the same region as the investors who bought their securities. In those days, Canada was well served by a provincially based regulatory structure.

Those days are gone.

Driven by the appearance of new technologies, deregulation, declining trade barriers, new competitors and new financial products, capital markets that were once local are now national and international. Businesses today raise capital where it is most readily available and least expensive. Investors search global markets for the best risk-adjusted returns. Financial intermediaries serve their clients and customers across regions, borders and continents. Competition for capital will only increase as these trends develop, particularly when China and India become fully integrated into the world economy. The attractiveness of Canada's capital markets, at home and abroad, depends in no small measure on the quality of securities regulation in this country.

Reform of Canada's securities regulatory structure and the development of a national capital markets strategy are issues of fundamental importance for every Canadian. Almost all Canadians today are investors in the equity markets, either directly or through mutual funds and pension funds. Debt markets are critical to the financing of infrastructure and public institutions. Capital markets underpin investment, support job creation and lead to higher standards of living. Fair and vibrant capital markets are vital for Canada to reach its full economic potential.

> Sound and effective regulation and the investor confidence it generates are important for the integrity, growth and development of securities markets. In turn, a robust and competitive securities market is vital to the health and vitality of Canada's economy.
>
> *Canadian Chamber of Commerce*

In light of these realities, other countries have taken active steps to improve their global competitiveness by reforming their regulatory structures. Canada must keep pace with these changes.

Canada's securities regulatory architecture must change so that our capital markets become a source of comparative advantage. Canadians need a world-class regulatory structure geared to the unique characteristics and opportunities of our economy.

It's time.

The World Has Changed

During the past two decades the world economy has changed. Technological changes have radically increased the mobility of capital. Trade barriers have fallen. The European Union has been greatly expanded. China, Russia and India are integrating into world capital markets.

These sweeping changes have resulted in vigorous global competition for capital. The rules of engagement are simple. Capital flows to destinations that engender investor confidence and offer the most attractive risk-adjusted returns.

> ... the recent globalization of financial markets has highlighted the inefficiency of the current Canadian system.
>
> *Desjardins Ducharme Stein Monast*
> *Montreal, Quebec*

Between 1980 and 2000, private capital flows (including gross bank flows, portfolio flows and foreign direct investment) increased more than six-fold to nearly US$4 trillion annually worldwide.[1] By 2003, outstanding international debt securities worldwide totalled US$10.3 trillion, a ten-fold increase from 1987 levels.[2]

Multinational securities firms now conduct business around the world and around the clock. Exchanges and trading systems operate on a cross-border basis. Globex Alliance is a global trading alliance of six derivative trading exchanges from around the world, including the Bourse de Montréal.[3] Euronext is a multinational European securities exchange operating in Belgium, France, the Netherlands, Portugal and the United Kingdom. The TSX Group Inc. (TSX Group), from its Toronto base, is spearheading an ambitious effort to forge mutual recognition agreements among stock exchanges around the world.

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1 Gordon Boissonneault, *The Relationship between Financial Markets and Economic Growth: Implications for Canada* (WPC Research Study 2003) (Financial Markets and Economic Growth Study) at 53.

2 Ibid at 51.

3 The Globex Alliance consists of six exchanges: the Bourse de Montreal, Chicago Mercantile Exchange, Paris Bourse, Singapore Exchange Derivatives Trading Ltd., Bolsa de Mercadorias & Futuros, and Spanish Futures and Options Exchange.

The Demands on Regulators Have Changed

As capital markets have become more integrated, the need for harmonization of regulatory content and standards has increased. As capital markets and financial instruments have grown in complexity, so too have the demands on regulators.

Regulators must now deal with conglomerates operating across national borders, with transactions involving parties in multiple jurisdictions and with complex new products. Given the intense competition for capital and the prevailing concerns over market integrity, regulators must strike a fine balance between ensuring efficient capital markets for issuers and maintaining adequate protection for investors.

Faced with these challenges, regulators need specialized expertise, a broad international perspective, sophisticated technology platforms and sufficient resources to be successful. They must respond to growing demands for closer cooperation in their supervisory roles and for harmonization to common international standards. For example, the International Organization of Securities Commissions (IOSCO) is promoting global harmonization of securities settlement systems, disclosure standards for cross-border offerings and listings, and increased international cooperation in enforcement matters.

> The future of the securities industry in Canada is being shaped by cross-border and product convergence considerations.
>
> *Raymond James Limited*
> *Vancouver, British Columbia*

In this environment, the efficacy of securities regulation is in the spotlight. If foreign investors lack confidence in Canada's system of securities regulation, they will be less likely to invest in Canadian firms, depriving Canadian issuers of an important source of capital. If foreign issuers decline to participate in Canadian markets because of regulatory complexity, Canadian investors will be deprived of investment opportunities. Moreover, if Canada's capital markets do not provide ready access to capital on internationally competitive terms, Canadian issuers will be forced outside Canada for their capital needs.

A further consequence for regulators is the fact that in integrated capital markets, events in one jurisdiction have spillover effects on others. The loss of investor confidence arising from the Enron and WorldCom scandals is an example. Although these events occurred in the United States, their effects were felt around the world. In its submission to us, the Canada Pension Plan Investment Board notes that:

> ... two-thirds of Canadians clearly recall the corporate scandals of the past few years, almost one third feel that half or more of publicly traded companies inflate their stated earnings and three-quarters say that corporate scandals have reduced their confidence in stock markets.

In this environment, the responsiveness and adequacy of securities regulators are tested in ways they never were in a less integrated world.

The Growing Importance of Capital Markets

A sound and progressive financial system, of which capital markets are a critical component, is a key driver of long-term economic growth. A research paper published with this report demonstrates the causal link between financial systems and economic growth.[4] A country's financial system plays a pivotal role in ensuring that savings are allocated efficiently to investments. Countries that are best able to channel savings into productive investments will register higher rates of growth and more rapid increases in living standards.

While traditional bank lending remains a cornerstone of Canada's financial system, capital markets are playing an increasingly important role. In 2002, capital markets provided 88% of the long-term financing of Canadian firms, compared to only 73% in 1990.[5] They are especially important in financing emerging companies that have yet to display the financial track record of more established concerns.

Well regulated capital markets are attractive to domestic and international investors, provide funds for issuers that might otherwise be deprived of access to capital, support a competitive market for the services of financial intermediaries and contribute to economic strength. Poorly regulated markets inhibit capital formation and economic growth.

Canada's Capital Markets Have Changed

Canada's capital markets are now overwhelmingly national in scope. The most dramatic example is the consolidation of Canada's stock exchanges. Before 1999 Canada had five regional stock exchanges, each reflecting its unique business environment.[6] Recognizing that, for the most part, regional Canadian capital markets had become national in scope, the exchanges were rationalized.

Today, Canada has four national exchanges. Senior equities are traded on the Toronto Stock Exchange (TSX) and junior equities are traded on the TSX Venture Exchange. The Bourse de Montréal is Canada's national derivatives exchange and the Winnipeg Commodity Exchange is Canada's national commodity futures and option exchange.

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4 See Financial Markets and Economic Growth Study.

5 Bank of Canada.

6 These were the Montreal Exchange, Toronto Stock Exchange, Winnipeg Stock Exchange, Alberta Stock Exchange and Vancouver Stock Exchange.

The national character of today's equity markets is evidenced by the following:[7]

- Two thirds of the approximately 7,600 reporting issuers in Canada are reporting issuers in more than one jurisdiction.
- All listed companies, including those that are reporting issuers in only one province, are necessarily interprovincial, since investors from across the country – and around the world – can buy or sell listed securities over the exchanges.
- Of the approximately 3,800 companies listed on the TSX and TSX Venture Exchange, almost 1,200, or 31%, are "national issuers" – reporting issuers in all 10 provincial jurisdictions.
- 777 companies with a market capitalization over $75 million – almost all of which are national issuers – accounted for $1.275 trillion, or 98%, of the approximately $1.3 trillion total market capitalization in Canada.[8]

> In the past, financial markets were sometimes local or intra-provincial, but today are rarely so. Most markets are global in scope and access, but securities regulation in Canada is still very much provincial.
>
> *Canadian Imperial Bank of Commerce*

Canada's debt market is largely national in scope. Of the $4.4 trillion in bond trading activity in 2002, 86% was in Government of Canada bonds.[9]

The vast majority of the 1,956 mutual funds offered for sale in Canada at the end of last year were offered for sale in all provinces and held by investors across the country.[10]

> ... the mutual funds industry in Canada is national and needs to be regulated nationally and on a uniform basis.
>
> *The Investment Funds Institute of Canada*

Canada's brokerage industry is national in scope. In mid-2003 there were 205 investment dealer firms operating in Canada. Integrated firms, which serve both the institutional and retail markets, accounted for 72% of total industry revenues in the second quarter of 2003 and are dominated by the investment dealers of the big six banks, which operate nationally and internationally.[11]

The national nature of the capital markets extends to the organizations that oversee capital market participants. Market Regulation Services Inc. (RS), co-owned by the Investment Dealers Association of Canada (IDA) and the TSX Group, is responsible for market surveillance, investigation and enforcement. The IDA regulates the activities of investment dealers across Canada. The Mutual Fund Dealers Association of Canada regulates the activities of mutual fund distributors, while the Canadian Investor Protection Fund is a national trust fund that protects investors in the event of the insolvency of a member firm.

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7 SEDAR data as of December 31, 2002.

8 The 60 companies constituting the S&P TSX 60 index are all national issuers, with 36 reporting in the territories as well (Ibid). These 60 issuers accounted for 51.6% of the total market capitalization of the TSX. See *Toronto Stock Exchange Review* (May 2003).

9 Bank of Canada.

10 Investment Funds Institute of Canada, *Monthly Statistics* (September 2003).

11 Investment Dealers Association, *Quarterly Securities Industry Statistics* (2003Q2).

The infrastructure supporting capital markets trading activity is also national. Clearing, settlement and payment for trades are handled by the Canadian Depository for Securities, the Canadian Derivatives Clearing Corporation and the Canadian Payments Association.

Canada's capital markets are also increasingly international. Cross-border transactions in Canadian equities have grown to 38% of GDP in 2002 from 5% in 1990.[12] In eight of the past ten years, Canadian issuers raised more debt internationally than domestically.[13] A significant number of Canadian issuers are interlisted on foreign stock exchanges. Seventy-eight Canadian issuers are listed on the New York Stock Exchange, while 81 are traded on the NASDAQ.[14] A number of firms are also listed on exchanges in Europe and Australia.

Although Canada's capital markets have changed and are now clearly national and international in both scope and operation, the regulatory structure has not kept pace. As the TSX Group states in its submission, "Canada now has a mismatch between the market and its regulatory architecture".

Canadian Investors Have Changed

More Canadians own securities than ever before. Forty-six per cent of Canadians now own publicly traded equities, either directly or through mutual funds – double the proportion at the start of the 1990s.[15] If indirect holdings through pension funds are included, almost all Canadians are invested in the public equity markets. The Bank of Canada has estimated that direct and indirect holdings of equities accounted for nearly 20% of total household assets at the end of the first quarter of 2003.[16] These holdings are used to pay for new homes and education for children, and represent the core of many Canadians' retirement savings. Research has shown that as portfolio values increase, so does consumer spending, which promotes economic growth.[17] Given the growing magnitude of Canadians' ownership of equities, the strength of the consumer side of the Canadian economy is increasingly dependent on equity market values.

As the importance of securities ownership to the welfare of Canadians increases, so does the importance of effective capital markets regulation. Canadians expect the securities regulatory structure to provide investors across the country with equal access to financial products and consistent and effective enforcement.

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12 Defined as total non-resident purchases and sales of outstanding Canadian stocks as a share of nominal GDP. Statistics Canada, *Canada's International Transactions in Securities* (August 2003).

13 Bank of Canada.

14 As at September 30, 2003.

15 TSX Group, *Canadian Shareowners Study* (2003).

16 Based on Statistics Canada, *National Balance Sheet Accounts, Quarterly Estimates* (2003Q2).

17 Rough estimates by the Bank of Canada suggest that a $1 increase in household wealth will boost consumption by approximately 10 cents. The effect of increases in the value of equity portfolios is smaller, however – approximately 5 cents for every $1 – since stock values are more volatile than other assets. Estimates of the wealth effect of equity portfolios on U.S. consumption range from 3 to 5 cents. See James Poterba, "Stock Market Wealth and Consumption" (2000) 14 Journal of Economic Perspectives 99.

The Enron and WorldCom scandals had serious repercussions on investor confidence in Canada, as elsewhere, and contributed to the global bear market after the technology sector revaluation. From the market peak in 2000 to the trough in 2002, more than US$13 trillion of global market capitalization was wiped out, including C$750 billion in Canada.[18]

The Governor of the Bank of Canada expressed the expectations Canadians have of their securities regulators when he stated:

> … confidence must be constantly earned by corporate managers and directors, auditors, analysts and investment advisors, rating agencies and regulators …. And when unscrupulous market participants or practices are revealed, authorities must come down on them with full force. To do otherwise is to do markets a disservice. Only strict reprobation will restore and maintain confidence that the rules are being enforced.[19]

Many of the market participants who spoke to us do not believe that the Canadian regulatory system meets these expectations. There is a widely held view that enforcement in Canada is lax in comparison with the United States and other countries. Some note that Canada has had its own share of corporate scandals, such as Bre-X and YBM Magnex, that have damaged domestic and international confidence in Canada's capital markets. Others worry about a growing perception that Canada's markets are susceptible to unreported and unpoliced insider trading.

Investors and issuers are demanding better enforcement. Investors, large and small, are concerned about protecting their investments, and issuers know that a tainted market will increase their cost of capital.

Regulatory Structures Around The World Are Changing

Other countries have been adapting their regulatory structures to the demands of these new realities. Many have radically restructured their regulatory systems or are in the process of doing so. These efforts have taken several different forms, but share a consistent underlying rationale – the realization that in a rapidly changing capital markets environment, legacy structures are inadequate and must be reformed.

It is instructive for Canada to consider what has happened elsewhere, and why. We commissioned research studies relating to the regulatory systems in the United States, the European Union and Australia to provide an international benchmark of regulatory change.[20] These studies clearly demonstrate that international policy makers are determined to ensure that their countries have competitive securities regulatory structures.

> …every other industrial country has recognized the national character of securities markets and adopted a national approach.
>
> *TSX Group*

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[18] ABN Amro, *Global Investment Returns Yearbook* (2003) and *Toronto Stock Exchange Review* (August 2000 and October 2002).

[19] Governor David Dodge, "Trust, Transparency, and Financial Markets" (Remarks delivered in Halifax, June 11, 2002).

[20] Joel Seligman, *The United States Federal-State Model of Securities Regulation* (WPC Research Study 2003) (U.S. Study); Karel Lannoo and Mattias Levin, *Securities Market Regulation in the EU: The Relation Between the Community and Member States* (WPC Research Study 2003) (EU Study); and Ralph Simmonds and Ray Da Silva Rosa, *The Impact of Federalising Securities Regulation in Australia: A View from the Periphery* (WPC Research Study 2003) (Australia Study).

The Australian experience is particularly interesting for Canada. Following a series of financial crises in the 1980s, power to administer securities legislation, previously exercised by the states and territories, was conferred in 1991 on a regulatory agency established by the Australian federal government. In 1999, following the Wallis Inquiry, which assessed how best to position Australian financial markets in an increasingly competitive world, all financial institutions and markets in Australia were brought under the supervision of two national regulators. The Australian Securities and Investment Commission (ASIC) regulates the market conduct of all financial sector industries (including securities, banking, insurance and pensions). The Australian Prudential Regulation Authority is charged with the safety and soundness of financial institutions. The research study notes that Australia's capital markets, including their regional components, have flourished under the new structure.

The United Kingdom has also recently reformed its regulatory system. The Financial Services Authority (FSA) assumed authority in 2001 for the functions previously carried on by nine regulators. This integrated financial sector regulation responded to the convergence of financial products and services in the banking, insurance and securities industries, and also reflected the search by the United Kingdom for competitive advantage in the European financial marketplace. To date, the FSA appears to be serving the capital markets of the United Kingdom well.

There is considerable regulatory reform in Europe. A single financial services regulator is being adopted by many countries, including Ireland and Germany. In addition, the European Union has embarked upon an elaborate process of updating its securities regulatory structure.

The European Union views capital markets integration as key to the achievement of its ambitious objective of a single financial market. Its previous efforts to achieve integration though a mutual recognition system were not successful. As a result, in 2001 a committee commissioned by the European Union and chaired by Baron Alexandre Lamfalussy proposed a process to achieve more integrated capital markets among the 15 (soon to be 25) countries of the European Union, with their disparate regulatory histories, legal systems, languages and business practices.[21] This process, outlined in detail in the EU Study, seeks to establish a framework for developing a passport system throughout the European Union to achieve "one-stop shopping" by capital market participants.

Developments in the United States are also of interest. The National Securities Markets Improvement Act of 1996 (NSMIA) resulted in increased national regulation of the U.S. capital markets. By empowering the Securities and Exchange Commission (SEC) to regulate exclusively in areas that had also been subject to state regulation, NSMIA significantly reduced redundant capital markets regulation.

[21] Final Report of the Committee of Wise Men on the Regulation of European Securities Markets (2001) (Lamfalussy Report).

Against this backdrop, the Canadian financial sector regulatory structure appears antiquated. Although the traditional "four pillars" structure of financial services delivery (under which banks, insurance companies, trust companies and securities firms had well defined specific spheres of activity) has, for the most part, been superseded by legislative changes over the last 20 years, the regulatory structure has remained largely unchanged.[22] There continue to be over 30 financial sector regulators in Canada, including 13 securities regulators.

Canada's securities regulatory structure has become an international outlier. As the Ontario Securities Commission (OSC) asserts in its submission, of the more than 100 countries (including 20 with federal political structures) represented at IOSCO, only Canada and Bosnia-Herzegovina lack a national or supra-national regulator.

> Clearly, those countries having a single securities regulator with one set of rules, consistency in enforcement and clearly understandable filing and disclosure requirements are a superior model to Canada's multi-jurisdictional structure.
>
> *TransCanada Corporation*
> *Calgary, Alberta*

The Call for Change in Canada

Perhaps the most striking aspect of the current debate about reforming Canada's securities regulatory structure is the almost unanimous agreement among capital market participants, regulators and provincial governments that Canada's current system must change.

Market Participants

We received 92 written submissions from capital market participants across the country, including investors, issuers, intermediaries, industry associations, regulators and others interested in improving the efficiency and effectiveness of the Canadian securities regulatory system.[23] We also received extensive input from members of the capital markets community during nine days of public consultations in Halifax, Montreal, Toronto, Winnipeg, Regina, Calgary and Vancouver, as well as from Canadian legislators and regulators. In addition, we consulted with regulators and capital market participants in the United States and Europe and met with representatives of the European Commission, the SEC, the FSA, the New York Stock Exchange and NASDAQ, among others.

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[22] There have been moves in some provinces to unified financial sector regulation. The Saskatchewan Financial Services Commission came into being on February 1, 2003, integrating the three major organizations that regulate financial services in Saskatchewan: the Saskatchewan Securities Commission, the Financial Institution Section of the Consumer Protection Branch and the Pension Benefits Branch of the Saskatchewan Department of Justice. Ontario has proposed merging the OSC and the Financial Services Commission of Ontario to create the Ontario Financial Services Commission, which would regulate securities, pension, insurance and other financial services sectors in Ontario. The Quebec government is in the process of merging the Commission des valeurs mobilières du Québec, Bureau des services financiers and Inspecteur général des institutions financières into a new super-agency, the Agence nationale d'encadrement du secteur financier du Québec.

[23] These submissions are available on the Committee's web site at www.wise-averties.ca.

Of the 77 submissions that make specific recommendations as to the best regulatory structure for Canada, 57, or 74%, recommend a single regulator. Included among them are:

- 21 of 22 TSX 60 issuers that made submissions to the Committee;
- five of the six biggest Canadian banks;
- the Canadian Council of Chief Executives, which represents the chief executives of over 150 of Canada's leading enterprises;
- the Canadian Bankers Association, which represents 41 financial institutions;
- the Canada Pension Plan Investment Board and the Ontario Teachers' Pension Plan, two of Canada's largest investors;
- the Small Investor Protection Association;
- the Prospectors and Developers Association of Canada, representing 4,000 individual and 250 corporate members; and
- the TSX Group.

Thirteen per cent recommend a passport system, but almost none specifies what such a system would entail. Individual investors are nearly uniform in demanding systemic change with improved investor protection and enforcement.

> Canada's capital markets have suffered for many years from excessive fragmentation that undermines both their efficiency and their dynamism .... The need for significant reform has become too compelling for any government or market participant to ignore.
>
> *Canadian Council of Chief Executives*

The Association for Investment Management and Research (AIMR), an organization that represents 8,000 financial analysts, portfolio managers and other investment professionals in Canada, conducted an extensive survey of its members on the adequacy of Canada's regulatory system. Over 90% of respondents indicated that the system needs change, 75% called for the creation of a single regulator, and 11% favoured either a passport system or uniform securities legislation.[24]

In March 2003 the Ontario Minister of Finance received the final report of the Five Year Review Committee (chaired by Purdy Crawford), which reviewed the legislation, regulations and rules relating to matters dealt with by the OSC and the legislative needs of the OSC. The first recommendation in the report is a forceful call for a single Canadian securities regulator. The report describes this as the "most pressing securities regulation issue in Ontario and across Canada".[25]

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[24] AIMR submission to WPC.

[25] *Five Year Review Committee Final Report: Reviewing the Securities Act (Ontario)* (2003) (Crawford Report) at 29.

Provincial Governments and Regulators

Provincial governments share the view that Canada needs to reform its regulatory structure. On June 11, 2003, a steering committee of provincial ministers in charge of securities regulation in the provinces of Alberta, Ontario, Quebec, British Columbia, Manitoba and Saskatchewan released a discussion paper (Provincial Ministers Discussion Paper) for comment. The paper states that provincial and territorial ministers are committed to making "significant reforms" in response to changes in capital markets.[26] It proposes a passport system of securities regulation that would authorize participating jurisdictions to enter into agreements to enable one jurisdiction's regulator to rely on a primary regulator in another jurisdiction to perform its supervisory duties regarding market access rules.

Regulators have embraced the need for reform. The Canadian Securities Administrators (CSA), the umbrella group of the 13 provincial and territorial securities regulatory authorities, has also embarked on a major reform initiative with its Uniform Securities Legislation (USL) Project. The goal of the USL Project is a uniform securities act and uniform rules to be adopted by each jurisdiction in Canada. The CSA has stated as its objective that the uniform act and uniform rules would be "word-for-word uniform in each jurisdiction" and "would provide a national framework for securities regulation".[27] Among other things, the USL contemplates comprehensive inter-delegation of functions among regulators, which would be similar in result to the passport system proposed by the provincial ministers.

The Committee Agrees There Must Be Change

We have concluded that major change to Canada's regulatory system is both necessary and overdue.

There are a number of weaknesses in the present system. Insufficient resources are directed towards enforcement. Wrongdoers too frequently go unpunished, and adjudication is unduly delayed. Coordination difficulties impede investigations and can lead to multiple proceedings that are inefficient and unfair. There are disparate priorities and a lack of uniform investor protection. Policy development is characterized by compromise and delay. Canada cannot respond as effe ely or innovate as quickly as it should in the fast-changing global marketplace. The system is too costly ie multiplicity of regulators leads to an inefficient allocation of resources and unnecessary opportunity and compliance costs. Internationally, Canada's securities regulatory structure is recognized as being unnecessarily complex. No one is mandated to represent the national interest in dealing with international securities regulators and other policy makers.

We commend those who, despite the limitations of their mandates, are working hard within the present system to achieve good results. Even their best efforts, however, cannot overcome the limitations of the current structure. Canada's regulators need an improved platform.

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[26] Provincial Ministers Discussion Paper at 1. According to the Provincial Ministers Discussion Paper, "[a]n efficient, effective, streamlined and simplified regulatory framework remains an important, as yet unrealized objective" (at 3).

[27] *Blueprint for Uniform Securities Laws for Canada* (2003) (Blueprint Paper) at 4-5.

Who Has the Responsibility for Change? Addressing a Misconception

The provinces have regulated capital markets using their jurisdiction over "property and civil rights" set out in subsection 92(13) of the *Constitution Act, 1867*. When the provinces first exercised that jurisdiction, capital markets were far more local than they are today. As we have indicated, they are now overwhelmingly national and becoming more international. This has made it increasingly difficult for the provinces to regulate effectively.

The history of provincial regulation has led to a misconception that the federal government lacks jurisdiction over capital markets. This is not the case. The federal government has the constitutional authority to pass comprehensive legislation regulating all capital markets activity within Canada.

We draw this conclusion from three constitutional opinions provided to the Committee from leading experts in Quebec, Ontario and British Columbia. Each of the opinions independently and strongly concludes that the federal government has the constitutional authority to regulate all aspects of capital markets activity pursuant to its power to legislate in respect of the "general regulation of trade" under subsection 91(2) of the *Constitution Act, 1867*.

We are publishing these constitutional opinions with this report. They speak for themselves in detail on this important topic.

This is a significant conclusion. The opinions are, of course, based on constitutional jurisprudence. We merely add that the legal conclusion corresponds with the common sense reality that the government of any country should have the legislative power to protect, buttress and enhance its economy in the interests of the well-being of all its citizens.

An Unprecedented Opportunity for Change

This is not the first time that Canadians and their governments have considered whether to reform Canada's securities regulatory structure. Unlike prior efforts, however, there is now an unprecedented opportunity – and a necessity – for change.

Issuers, investors and financial intermediaries across Canada are united in their call for change. Markets around the world and their regulatory structures are rapidly changing. Other countries are finding ways to achieve competitive advantage through their securities regulatory structure. Canada should do no less.

The remainder of this report is dedicated to the question of what form this change should take.

We add one word of caution. Some may urge only minor adjustments to the present structure, leaving major change for a second round. We strongly believe that this would not be in the national interest. Should Canada's capital markets be eroded through insufficient attention to this important issue they would not easily be restored. The direct negative impact upon the economy, and the welfare of individual Canadians, would be pronounced.

> Tinkering with the status quo is not enough. Bold steps are required.
>
> *Fidelity Investments Canada Limited*
> *Toronto, Ontario*

While the securities regulatory structure is only one element of vibrant capital markets, it is an important one. We urge governments to address the issue – and to address it now.

It's time.

CHAPTER TWO

Canada's Current Regulatory Structure and Its Strengths

The Current Structure

Each of Canada's 13 provinces and territories has a separate securities regulatory authority administering a separate set of securities laws. They are the: British Columbia Securities Commission; Alberta Securities Commission; Saskatchewan Financial Services Commission; Manitoba Securities Commission; Ontario Securities Commission; Commission des valeurs mobilières du Québec; New Brunswick Securities Administration Branch; Nova Scotia Securities Commission; Prince Edward Island Securities Office (Office of the Attorney General); Securities Commission of Newfoundland and Labrador; Registrar of Securities (Community Services), Government of the Yukon Territory; Registrar of Securities (Department of Justice), Government of the Northwest Territories; and Registrar of Securities (Department of Justice), Government of Nunavut.

The securities regulators are not uniform in either structure or function. Four are self-funded government agencies, five are structured within government departments and the rest occupy a spectrum between the two extremes with respect to funding and governance. The largest regulators have significant professional staff, make rules, formulate policy and sit as administrative tribunals. The smallest regulators are thinly staffed and perform only certain of these functions.

Although provincial and territorial securities law statutes are based on similar principles and objectives and, in many areas, are substantively very similar, none of them is the same. There are differences in both the legislation and its administration. Rules, which have supplanted legislation and policies as the primary source of regulation, vary from jurisdiction to jurisdiction. Indeed, some jurisdictions do not have rule-making authority.

Canadian Securities Administrators

Recognizing the difficulties inherent in this fragmented regulatory structure, the Canadian Securities Administrators was created as a forum for Canada's provincial and territorial regulators to improve regulation of Canadian capital markets. It is an informal body that functions through meetings among its members. The CSA has no binding authority over the securities regulators regarding policy development or enforcement activities and is funded by each of its members on a voluntary basis.

Until recently the CSA was not separately staffed and had to rely on the resources of the provincial regulators for policy development. On September 4, 2003, however, the CSA announced the creation of a permanent secretariat located in Montreal consisting of an executive director, a policy coordinator and support staff. In addition, the CSA established the new Policy Coordination Committee (PCC), consisting of six members appointed for two-year terms to oversee the implementation of the CSA's strategic plan and ongoing policy and rule development. The first PCC members are the chairs of the securities commissions in British Columbia, Alberta, Manitoba, Ontario, Quebec and Nova Scotia. The CSA also has a new governance structure in which the CSA chair and vice-chair will be elected by the CSA members for two-year terms.

The CSA has undertaken several significant initiatives to harmonize securities laws and the administration of those laws across Canada. These include the following:

- *National instruments and national policies* – The development and implementation of 25 national instruments and 24 national policies covering key areas such as prospectus requirements, mutual fund regulation, rights offerings, take-over bids, registration issues and marketplace operations.
- *Mutual Reliance Review System (MRRS)* – A system in which one securities regulator is designated as the "principal regulator" on which other jurisdictions rely for analysis and review of filings and exemptive relief applications.
- *System for Electronic Document Analysis and Retrieval (SEDAR)* – A web-based system that facilitates the electronic filing of securities information as required by provincial and territorial regulators and that provides public access to most disclosure documents filed by reporting issuers.
- *System for Electronic Disclosure by Insiders (SEDI)* – A web-based system that facilitates the filing and public viewing of reports on securities trading by insiders of reporting issuers.
- *National Registration Database (NRD)* – A web-based system that permits dealers and advisers to file registration forms electronically.
- *USL Project* – A project with the goal of developing uniform securities legislation and uniform rules for adoption by each jurisdiction in Canada.

Mutual Reliance Review System

Perhaps the most important CSA initiative implemented to date has been the MRRS. Introduced in 1999, the MRRS is a system in which a decision maker in one jurisdiction is prepared to rely primarily on the analysis and review of regulatory staff in another jurisdiction. Prospectus review, exemptive relief applications, initial and renewal annual information forms, waiver applications and pre-filings fall within the scope of the MRRS.

For example, if an issuer wishes to issue securities by way of a prospectus in more than one jurisdiction in Canada, the MRRS allows the issuer to deal with one principal regulator (usually the regulator in the jurisdiction where the issuer's head office is located) rather than with each of the regulators in the jurisdictions in which the securities are being offered. Staff of the principal regulator provide comments to the issuer on behalf of all of the commissions and make recommendations. The issuer then receives a single decision document from the principal regulator.

The MRRS is a formalized approach to voluntary cooperation among regulators. None of them surrenders any jurisdiction or discretion. Each regulator retains its statutory discretion with respect to all matters being considered under mutual reliance and can "opt out" of the system at any time and deal directly with the market participant. No changes have been made to securities laws as a result of the MRRS. In fact harmonization is not an objective of the MRRS. The CSA has stated that harmonization is "an indirect benefit that may be achieved over time".[1]

Though not without flaws, the MRRS represents a significant step forward in streamlining the regulatory process when more than one jurisdiction is involved. It has not, however, led to uniform securities laws across the country. It does not obviate the need for capital market participants to be familiar with and comply with the 13 separate sets of rules and regulations across the country. The MRRS has not reduced fees, since capital market participants must still pay fees to non-principal jurisdictions. It also does not ensure uniform or predictable treatment, since any regulator has the right to opt out of the system at any time.[2]

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1 CSA Notice, *Mutual Reliance Review System Memorandum of Understanding* (1999)

2 It is important to note, however, that it is increasingly uncommon for jurisdictions to opt out of the MRRS. Anita Anand and Peter Klein, *The Costs of Compliance in Canada's Securities Regulatory Regime* (WPC Research Study 2003) (Costs Study) at 547.

Self-Regulatory Organizations

Self-regulatory organizations (SROs) play an important role in Canada's regulatory structure. SROs are subject to recognition orders and oversight by provincial regulators. The major SROs and related regulation service providers operating in Canada and the roles they perform are:

- *Investment Dealers Association of Canada (IDA)* – The IDA is a national association that regulates the activities of investment dealers, including their capital adequacy and business conduct. Its mandate includes registration, financial compliance, sales compliance, and enforcement. The IDA investigates complaints against member firms or their registered employees and has the authority to prosecute individuals and firms suspected of wrongdoing, as well as to impose reprimands, fines or suspensions, or order expulsions.

- *Mutual Fund Dealers Association of Canada (MFDA)* – The MFDA is responsible for regulating the activities of mutual fund distributors and has the power to perform compliance reviews and enforce rules through a disciplinary process that can result in fines, suspension or termination of membership.

- *TSX and TSX Venture Exchange* – Firms must comply with rules and policies of the TSX or TSX Venture Exchange to obtain and maintain a listing.

- *Bourse de Montréal (ME)* – Trading activity in derivatives on the ME is regulated by the ME, as are investment dealers in Quebec.

- *Market Regulation Services Inc.* – Trading on the TSX and TSX Venture Exchange is regulated by RS, an independent regulation services provider. Areas of responsibility include market surveillance, investigation and enforcement.

- *Canadian Investor Protection Fund (CIPF)* – The CIPF is an industry-sponsored investment fund that ensures, subject to defined limits, that client assets are protected in the event of the insolvency of a Canadian investment dealer that is a CIPF member. CIPF plays a role in setting and reviewing minimum standards of capital adequacy, liquidity and financial reporting for investment dealers and in overseeing the financial position of such firms.

* * *

A careful analysis of the current regulatory structure's strengths and weaknesses is required in considering reform proposals. Our analysis was based on the submissions we received, our consultations with capital market participants, nine commissioned research studies, and our review of the existing literature on the subject.[3] While the purported strengths and weaknesses of the system are often cited, it is important to determine whether they are in fact strengths or weaknesses, and if so, their significance. Any changes to Canada's regulatory structure should preserve the strengths of the current system and address its weaknesses.

[3] The Committee's process is described in Appendix B. The research studies and the constitutional opinions are published in a companion volume.

Strengths of the Current Structure

The strengths of the current structure result from a local regulatory presence, which is a legacy of the days when Canada's capital markets were more fragmented.

Local Presence

Effective enforcement requires a degree of local presence to receive investor complaints, conduct investigations and react quickly to infractions.[4] The proximity of a regulator to those it regulates allows the regulator to know the capital market participants in its jurisdiction. As the research study we commissioned on public interest enforcement orders found, this leads to better enforcement:

> … it is apparent that, certainly in the bigger provinces, there were more than a few occasions where the respondents who were the subject of public interest hearings had previously come to the attention of that provincial agency…. While this may be something of a self-fulfilling prophecy, in the sense that enforcement staff might be quicker to act on a situation involving someone they are aware has been previously investigated, it does suggest that it is relevant to have a base of local expertise in relation to market participants and their activities.[5]

A local presence also facilitates dealings between the regulator and issuers and intermediaries. Regulators and capital market participants can meet "across the desk" to share perspectives, gain mutual understanding and resolve issues in a constructive and efficient manner.

These are important strengths that should be preserved in any reform of Canada's regulatory structure.

Development of Sectoral Expertise

Contact with capital market participants, when combined with the concentration of specific industries within a jurisdiction, has enabled the development of centres of regulatory expertise. A research study commissioned by the Committee found that the existence of "local infrastructures for capital raising" in various provinces could be inferred where there is a critical mass of issuers of a certain industry type or market capitalization.[6] This concentration allows local securities regulators as well as professionals (such as investment bankers, lawyers and accountants) to develop expertise in and be responsive to the needs of these issuers.

> The key strengths of the current Canadian securities regulatory system include a concentration of expertise and related regulatory activities in areas of Canada where there are corresponding concentrations of Canadian business and financial services.
>
> *Enbridge Inc.*
> *Calgary, Alberta*

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[4] See Charles River Associates, *Securities Enforcement in Canada: The Effect of Multiple Regulators* (WPC Research Study 2003) (CRA Study) at 489 and Mary Condon, *The Use of Public Interest Enforcement Orders by Securities Regulators in Canada* (WPC Research Study 2003) (Condon Study) at 440.

[5] Condon Study at 440-1.

[6] Poonam Puri, *Local and Regional Interests in the Debate on Optimal Securities Regulatory Structure* (WPC Research Study 2003) (Puri Study) at 213.

Based on the location of the headquarters of reporting issuers listed on the TSX and TSX Venture Exchange, the study found that local infrastructures for capital raising exist in: Alberta for oil and gas issuers; British Columbia for micro-cap issuers;[7] Ontario for financial services issuers; British Columbia and Ontario for mining issuers; British Columbia, Alberta and Ontario for small-cap issuers;[8] Ontario, Quebec and British Columbia for communications and media issuers; and Ontario and Quebec for life sciences issuers.

The existing system has facilitated the development of regulatory expertise in specific industry sectors. This is also an important strength that should be preserved. The current system, however, does not effectively leverage existing expertise to permit all Canadians to benefit from the specialization of provincially based regulators. For example, an oil and gas issuer based in Ontario that files a prospectus under the MRRS with Ontario as the principal regulator would not ordinarily benefit from the expertise of the Alberta Securities Commission (ASC), which would not be charged with reviewing the document.

Responsiveness to Distinctive Local and Regional Issues

A number of capital market participants have expressed their view that the current system is responsive to distinctive local and regional issues.[9] Research has found, however, that there are few issues, if any, that can qualify as truly local.

The location of an issuer's head office is not necessarily indicative of where its business is carried on or where the majority of its investors reside. For example, a small-cap mining company listed on the TSX Venture Exchange with its head office in British Columbia may conduct its exploration activities in Saskatchewan and have more Quebec shareholders than British Columbia shareholders. While the British Columbia Securities Commission (BCSC) may have developed expertise in regulating small-cap mining companies, it does not follow that the regulation of small-cap mining companies is of distinctive importance to British Columbia, unless a British Columbia resident investing in a small-cap mining stock can be shown to be in need of different regulation than a Quebec resident.

Similarly, even though certain industries may be concentrated in some provinces or regions, gross domestic product (GDP) data suggest that the economic significance of these industries transcends regional boundaries. For example, consider the concentration of head offices of financial services issuers in Ontario. GDP data by province and industry reveal that activity in the "finance, insurance and real estate" sector represents 22% of Ontario's GDP, but also represents 12% to 23% of the GDP of all other provinces and territories.[10] Therefore, as the research study notes, "it would not be valid to claim that financial services

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7 The Puri Study defined a "micro-cap" issuer as one with a market capitalization of less than $5 million.

8 The Puri Study defined a "small-cap" issuer as one with a market capitalization of between $5 million and $75 million.

9 See, for example, Bennett Jones LLP's submission:

> We have found that regulators that are closely tied to a capital market (in terms of geography) often have a much better sense of the business fundamentals that govern participants in that market. Such regulators are prepared to take the time to understand factual circumstances that present new issues and to be proactive in the search for solutions in those circumstances where the public interest is not prejudiced by a novel approach.

10 Puri Study at 228.

is an industry local to Ontario: financial services is important to the economies of all the provinces and no one province has inherent ownership in fostering the general growth of this industry or encouraging capital formation for this industry".[11]

In light of this analysis and our consultations, we have concluded that there are very few distinctively local or regional issues relevant to policy making.[12] Concentrations of issuers in a certain industry have resulted in the development of sectoral expertise in certain provinces, but do not prove the existence of distinctive local and regional issues. The Prospectors and Developers Association of Canada (PDAC) makes this point in its submission. The majority of its members are headquartered in Vancouver and Toronto. Despite this, PDAC points to the national character of the exploration industry:

> We believe that the exploration industry is a national industry for several reasons. First, the issuers are resident in primarily BC and Ontario but they also exist in Quebec, Alberta, Saskatchewan and the Maritimes. Second, investors are resident in primarily BC and Ontario but they also exist in Quebec, Alberta, Saskatchewan and the Maritimes. This means that issuers, regardless of their home jurisdiction, must raise financing in multiple jurisdictions – particularly as their projects advance. We don't accept the notion that certain provincial regulators should be charged with advancing the interests of certain industries or certain sized issuers because this implies that the other regulators are letting down companies or investors who reside in their jurisdictions. As well, we don't see why these so-called regional issues could not be handled by the local offices of a single regulator or by the office of a single regulator that is charged with administering the affairs of an industry or other issuer group.

A review of regulatory innovations by the provincial regulators confirms that they were not developed in response to purely local or regional issues. By virtue of the independence of Canada's 13 regulators, each has the ability to implement new policies when it sees fit. The benefit of provincial experimentation is that other jurisdictions may later adopt similar measures if they prove successful. There are examples of locally developed policies that have experienced multilateral or national adoption, such as Alberta's Junior Capital Pool Program,[13] British Columbia and Alberta's System for Shorter Hold Periods with an Annual Information Form,[14] and Ontario's introduction of the accredited investor exemption.[15]

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11 Ibid.

12 Enforcement raises greater local and regional issues, since enforcement priorities and administrative policies may vary from region to region depending on market activity. This issue is addressed in greater detail below.

13 Currently, the TSX Venture Exchange operates a Capital Pool Company Program in British Columbia, Alberta, Saskatchewan, Manitoba, Ontario and Quebec.

14 Now adopted by all of the Canadian securities regulators other than Quebec through Multilateral Instrument 45-102 *Resale of Securities*.

15 The "accredited investor" exemption was introduced by Ontario in OSC Rule 45-501 *Exempt Distributions* (OSC Rule 45-501) in November 2001. A similar accredited investor exemption was subsequently adopted by British Columbia and Alberta in Multilateral Instrument 45-103 *Capital Raising Exemptions* (MI 45-103) in April 2002, which also introduced additional exemptions that differ from those in OSC Rule 45-501. In June 2003, MI 45-103 was adopted by Saskatchewan, Manitoba, Nova Scotia, Newfoundland and Labrador, Prince Edward Island, the Northwest Territories and Nunavut. In addition, New Brunswick and the Yukon, which do not currently have rule-making authority, have agreed to consider applications for exemptive relief on a case-by-case basis and to consider the provisions of MI 45-103 in exercising their discretion – effectively making MI 45-103 available in those jurisdictions as well.

None of these policy initiatives, however, appears to have been in response to a distinctively local or regional issue. A research study reviewed these initiatives and noted that these three locally developed policies experienced relatively rapid multilateral or national adoption, were in response to concerns of investors located throughout the country, or were industry-neutral rules that allowed issuers to raise capital in a cost-effective manner.[16]

> It doesn't appear obvious that small issuers in Ontario are in any less need of ... small financing capital raising exemptions ... than small issuers in BC and Alberta.
>
> *Canadian Listed Company Association*

The research study found only one example of a local policy that responded to a distinctive local need: Saskatchewan Local Policy 45-601 *Community Ventures* (Community Venture Exemption). The Saskatchewan Securities Commission created the Community Venture Exemption in 1993. It allows issuers to raise up to one million dollars in a small geographical area of Saskatchewan[17] to fund the creation or development of a "Community Venture" to provide jobs in, or economic development of, the community. These exemptions have been used successfully by rural Saskatchewan communities for the development of local hog farms and grain terminals. More than a dozen large grain terminals in Saskatchewan began their operations using these exemptions, and subsequently conducted prospectus offerings to raise additional capital. According to the Saskatchewan Financial Services Commission, the ability of farmers to raise inexpensive early stage capital was directly attributable to these exemptions.[18]

An argument can certainly be made that when a province uses securities laws as a tool to promote local economic development, it is responding to a distinctive local and regional issue – the province's economic prospects. For example, a province may choose policies that facilitate capital formation in an attempt to stimulate economic growth.

There is an inherent conflict between the notion that provinces have distinctive economic and capital market needs, however, and efforts to harmonize provincial securities laws. The rules governing prospectus financings have largely been harmonized. Capital raising exemptions from the prospectus and registration requirements are becoming increasingly harmonized.[19] In addition, MI 45-103 was recently adopted by nine economically and geographically disparate jurisdictions. Finally, the CSA's USL Project seeks to harmonize capital raising exemptions across the country. Interestingly, while the Community Venture Exemption may be an example of a province using its securities laws to foster local economic development, the Saskatchewan Financial Services Commission is of the opinion that exemptions in MI 45-103 will likely supersede the Community Venture Exemption.[20]

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16 Puri Study at 249.

17 The venture must be located in a community of less than 5,000 people, and investors must be drawn from residents within a 20-km radius of the community.

18 Puri Study at 239.

19 The differences among these exemptions, although generally not material in terms of policy, give rise to unnecessary compliance costs. These are discussed in the section "Compliance Costs" in Chapter Three.

20 Puri Study at 239.

Differences in local enforcement priorities may be another example of responsiveness to distinctive local and regional issues. Research has found variations in the nature of infractions that are the subject of public interest enforcement orders.[21] In addition, there were differences between Manitoba and Ontario in the type of investigations pursued. Investigations of sales of unregistered securities rank as the most important category in Manitoba, but only 7th out of 10 in Ontario. Investigations of abusive trading practices rank first in Ontario, but only 4th out of 10 in Manitoba.[22]

It is not clear whether these differences reflect responsiveness to distinctive local needs or are a result of a lack of coordination of enforcement priorities and resource allocation. Research by Charles River Associates (CRA) has found that differences in socio-economic factors (such as per capita disposable income, income distribution of investors, particularly those over age 65, and distribution of firms by size) among provinces explain some of the differences in per capita investigations among regulators.[23] These factors may also account for differences in local enforcement priorities (i.e. certain jurisdictions may have more of certain kinds of infractions due to specific capital market activity).[24] The CRA Study also notes that it is important that:

> ... the extent to which enforcement *requirements* differ regionally is a separate issue from whether effective enforcement *activity* needs to be implemented locally. The two issues are frequently conflated. There is general acceptance that implementing an effective enforcement regime requires a local presence. This still leaves open the extent to which enforcement priorities should differ between regions, such that different rules and regulations are required.[25]

The ability to respond to distinctive local and regional interests is a strength of the current system, although we believe this strength is not as significant as some of its proponents claim.

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[21] In the Condon Study, public interest decisions from January 1, 2000 to June 30, 2003 from British Columbia, Alberta, Ontario and Quebec were reviewed, as were decisions from January 1, 1998 to June 30, 2003 from Saskatchewan, Manitoba, New Brunswick, Nova Scotia and PEI. A total of 83 decisions were reviewed, with a focus on three parameters: (i) the subject matter of the hearings; (ii) how the concept of the "public interest" was operationalized; and (iii) the specific nature of the sanctions imposed. The most striking area of variation was in the nature of the infractions that are the subject of public interest orders. There was notable consistency across the provinces on the articulation of the "public interest", but some unevenness in the application of contextual sentencing factors.

[22] CRA Study at 485. Manitoba and Ontario were the only two jurisdictions for which the researchers were able to obtain data.

[23] CRA used regression analysis to identify and isolate the effect of various factors of influence on enforcement activity in the provinces as well as several U.S. states. Overall the coefficient estimates indicate that enforcement responds to regional differences in socio-economic factors in predictable ways in both countries. However, the link between differences in socio-economic factors and enforcement activity is stronger in the United States than in Canada, which CRA speculates may be attributable to the centralizing function of the SEC, which enables state commissions to target activities that are highly state-specific. See CRA Study at 496-7.

[24] CRA speculates that the differences in investigative priorities in Manitoba and Ontario reflect differences between the two markets: "Ontario has a large number of public companies, many of which are large, and higher incomes that generate more investing activity and opportunities for misconduct such as insider trading. Manitoba is a much smaller province and therefore must deal with problems more likely to arise with smaller firms, such as selling unregistered securities". CRA Study at 485.

[25] CRA Study at 461 (emphasis in original).

Innovation

Some commentators contend that the existence of multiple regulators promotes regulatory innovation. In its submission, the BCSC notes that new ideas "get tested and proven up in one or a few jurisdictions and then spread to others, ultimately becoming the focus of harmonization". As discussed above, Alberta's Junior Capital Pool Program, British Columbia and Alberta's System for Shorter Hold Periods with an Annual Information Form, and Ontario's introduction of the accredited investor exemption are policies implemented in one jurisdiction that were later adopted elsewhere.

We believe that the potential for innovation is critical to any regulatory system. Indeed, regulators should be explicitly reminded that innovation forms part of their mandate. The current system has led to a number of innovations, but its track record in innovation is mixed. First, there are relatively few instances of local innovations that have later been adopted nationally. Second, the inevitable cost of local innovation is regulatory fragmentation, which increases compliance costs for as long as it takes for the new rule or policy to be adopted nationally. Third, innovation is sometimes impeded because of harmonization efforts designed to produce a solution acceptable to all regulators. This can have the effect of diluting or stifling potentially innovative regulatory approaches.

Summary of Strengths

The main strengths of the current system are the proximity of regulators to capital market participants in each jurisdiction and the development of expertise in specific industry sectors.

The existing system benefits somewhat from the innovation that arises from multiple regulators that are free to pursue their own policies. The same is true of responsiveness to local and regional issues, although we believe that this strength is somewhat overstated. Based on the evidence, what may first appear as responses to distinctive local and regional issues are more often responses to issues that transcend provincial borders, with the exception, perhaps, of the setting of certain enforcement priorities.

We note that none of these strengths is unique to the current system, and that each of them can and should be preserved in any new regulatory structure.

CHAPTER three

Weaknesses of the Current Structure

The Committee heard a litany of complaints about Canada's securities regulatory system: Canada suffers from weak and inconsistent enforcement and investor protection. Wrongdoers too frequently go unpunished, and adjudication is unduly delayed. Policy development is slow and inflexible. The need for consensus often results in a lack of uniformity, overregulation or policy paralysis. The system is too costly, duplicative and inefficient. The regulatory burden impedes capital formation. Canada's international competitiveness is undermined by regulatory complexity. Canada lacks a single securities regulator charged with representing the national interest.

As was the case when reviewing the system's strengths, we have carefully analyzed the purported weaknesses to determine the extent to which they exist and their significance.

> The multi-jurisdictional regime is rife with duplications and inefficiencies.
>
> *Nexen Inc.*
> *Calgary, Alberta*

Enforcement

One of the main and frequently repeated criticisms of the current system is that Canada does not enforce its securities laws effectively, especially when compared with the United States.

Approximately 50% of respondents in AIMR's survey of its members said the fairness, consistency and strength of enforcement in Canada are poor or very poor.[1] Ontario Teachers' Pension Plan is also critical of the enforcement process, noting in its submission that "enforcement activities with respect to significant matters are usually lengthy, drawn-out matters with little apparent progress in terms of reaching resolution". The most frequent complaint we heard from small investors was that the current enforcement system is inadequate and fails to protect their interests.

[1] AIMR submission to WPC.

The adequacy of Canada's enforcement has been seriously questioned for some time. The criticism intensified following the wave of corporate scandals in the United States involving companies such as Enron, WorldCom and Tyco. In Canada a number of high-profile corporate scandals have also occurred, including Bre-X and the massive fraud it represented. There is a perception both in Canada and abroad that serious misconduct in Canada too often goes unpunished.

> The greatest weakness of the regulatory system is that it does not protect investors.... There is ever more red tape and no real enforcement! The crooks rarely go to jail....
>
> *Jarislowsky Fraser Limited*
> *Montreal, Quebec*

Provincial and federal legislators and regulators have taken steps to address these concerns. Ontario has recently amended its securities legislation to create new offences, increase penalties and provide additional powers to the OSC.[2] The federal government has proposed amendments to the *Criminal Code* creating new offences and increasing the penalties for existing securities fraud offences, and has provided $120 million in new funding over the next five years for the establishment of dedicated investigation teams with capital markets expertise. The Insider Trading Task Force, comprising the OSC, BCSC, ASC, Commission des valeurs mobilières du Québec (CVMQ), IDA, ME, and RS, recently released a report containing a series of recommendations to combat illegal insider trading.[3]

Although these are positive developments, there are structural limitations of the current system that need to be addressed. They are (i) inefficient allocation of resources, (ii) coordination difficulties in multijurisdictional proceedings and (iii) unjustified variation in enforcement priorities and statutory protections for investors.

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2 *Keeping the Promise for a Strong Economy Act (Budget Measures)* (2002).

3 Insider Trading Task Force, *Illegal Insider Trading in Canada: Recommendations on Prevention, Detection and Deterrence* (2003) (Insider Trading Task Force Report).

Inefficient Allocation of Resources

The United States allocates a much greater percentage of its regulatory resources to enforcement than Canada. The SEC's enforcement budget accounts for approximately 29% of its total budget.[4] By contrast, British Columbia, Alberta, Quebec and Ontario each spend between 13% and 19% of their budgets on enforcement.[5]

The disparity in resource allocation to enforcement is reflected in enforcement activity in Canada and the United States. Studies have found more stringent enforcement in the United States, particularly with respect to insider trading.[6] Canada's lax enforcement of insider trading was reflected in a recent study that scrutinized the movement of share prices before merger and acquisition transactions. The study found that profits made by corporate insiders in Canada prior to the announcement of acquisitions are the highest among 52 countries studied.[7]

As will be discussed in detail below in the section "Costs of Duplication", the rationalization of Canada's securities regulatory structure would generate considerable savings. If some of these savings were spent on enforcement, Canada could significantly improve its performance in this area.

> Enforcement by a centralized regulator would avoid duplication of manpower and resources.
>
> *Phillips, Hager & North Investment Management Ltd. Vancouver, British Columbia*

A more centralized enforcement system would allow for the development and deployment of specialized staff throughout the country. The Committee heard repeated comments about the need for more specialization at every stage in the enforcement process – investigation, prosecution and adjudication – in order to combat the increasing complexity of securities violations. More centralized enforcement and increased specialization would result in improved investor protection across the country as well.[8]

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4 CRA Study at 474. The calculation is based on the total number of employees dedicated to enforcement relative to the total number of employees.

5 Ibid at 473.

6 See William J. McNally and Brian F. Smith, "Do Insiders Play by the Rules?" (2003) 29 Canadian Public Policy 125 at 138.

7 Arturo Bris, "Do Insider Trading Laws Work?" (Working Paper, February 2003) at 13. The Insider Trading Task Force Report notes (at 4) that "[t]he Task Force was formed out of concerns among its participating securities regulators that: there is a public perception that illegal insider trading is prevalent and increasing on Canadian markets, and although many suspected incidences of illegal insider trading are being identified through market surveillance, there have been few successful enforcement actions".

8 For example, if a particular jurisdiction had specific expertise (e.g. investigating revenue recognition abuses), its staff could be used to pursue those cases nationally.

Coordination Difficulties

Each regulator is responsible for enforcing its own provincial or territorial securities laws. Enforcement issues, however, frequently cross provincial borders. This necessitates coordination of enforcement efforts among multiple regulators.

Provincial securities regulators generally work well together on enforcement and compliance matters. Regulators' compliance departments share information in connection with reviews of registrants and issuers. However, compliance reviews can be slowed considerably because of coordination difficulties.

Investigations and enforcement proceedings may also be impeded if jurisdictions do not cooperate. Under current law an investigating jurisdiction must obtain the assistance of other jurisdictions to utilize their compulsory powers to gather evidence in those other jurisdictions. Provincial regulators also lack the ability to compel the attendance of a witness from another jurisdiction. Capital market participants can exploit these interjurisdictional limitations to avoid or delay investigations and proceedings. The OSC notes in its submission that:

> The increasing complexity of financial transactions means that inter-jurisdictional activity is becoming more the rule than the exception. On occasion, businesses with national scope hide behind the fragmented regulatory system as an excuse not to cooperate with commission investigations.

Moreover, when an offender is banned from participating in the capital markets in a jurisdiction, the offender may move to another jurisdiction and attempt to carry on business there. In order for the offender to be banned in additional jurisdictions, separate orders must be issued. This contributes to the perception that wrongdoers too often go unpunished under the current system.

A further weakness of the current system is the potential for multiple investigations and enforcement proceedings by different regulators in respect of the same respondent. The problems are illustrated by the insider trading case relating to trades allegedly made in connection with a take-over bid for Doman Industries Limited, which resulted in overlapping proceedings in both British Columbia and Ontario. The Cartaway Resources Corporation and Yorkton Securities cases are two more recent examples where different regulators brought multiple proceedings.

The regulators have recently made significant improvements in coordination and cooperation among themselves and SROs.[9] Today the number of cases pursued concurrently by more than one regulator is estimated to be less than 5% of the total, although overlap is most common in the highest-profile cases.[10]

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[9] For example, the BCSC reports that it meets monthly with representatives from the IDA, the TSX Venture Exchange and RS. It also meets quarterly with representatives from the Vancouver Police Department, the RCMP and Industry Canada. In addition, monthly conference calls and twice-yearly meetings are held with the enforcement divisions of the securities regulators to discuss matters of interest. RS engages in considerable communication with the regulators and the IDA, providing a monthly report to its recognizing commissions describing all investigations and prosecutions that have been opened and closed. See CRA Study at 500.

[10] Ibid at 462.

Coordination is typically effected through the appointment of a lead regulator (on an informal and cooperative basis) with primary carriage of the matter, joint investigations or hearings, or partitioning of the investigation.[11]

In the course of preparing its research study, CRA spoke to a number of securities litigators about multiple proceedings. They are uniform in acknowledging the progress the regulators and SROs have made in coordinating their efforts. Despite these improvements, however, they note that the multiplicity of regulators continues to add unnecessary cost and delay to the enforcement process. For example, parties under investigation do not have the assurance that a settlement reached with the lead regulator will be acceptable to other regulators.[12]

These coordination difficulties are costly and inefficient, and limit the ability of regulators to provide effective enforcement.[13] In addition to consuming scarce resources, multiple investigations and proceedings can also result in unfairness to respondents.

Inconsistent Priorities and Investor Protection

A further weakness of the current system is unjustified variation among the provinces and territories in enforcement priorities and statutory protections. As discussed, it is not clear to what extent differences in enforcement priorities across Canada are in response to distinctive local and regional issues. It is safe to assume, however, that while some differences may be justified by different local needs, all differences are not.

Differences in statutory enforcement provisions result in different levels of investor protection across the country. There is inconsistency in the enforcement powers and sanctions among the provinces. Regulators in British Columbia, Saskatchewan and Nova Scotia have the ability to make general compliance orders, whereas regulators in the other jurisdictions can only make orders requiring compliance with a specific portion of securities legislation. Likewise, there are varying powers to order restitution, disgorgement and/or compensation to investors, as well as to impose administrative fines.[14] As Osler, Hoskin & Harcourt LLP notes in its submission, "the result is that the same conduct can result in widely varying sanctions depending upon the jurisdiction in which it occurred and is prosecuted ".

> Why should Canadians in one province have different standards of legislated investor protection than in another?
>
> *Canada Pension Plan Investment Board*

[11] Ibid at 502.

[12] Ibid at 502-3. CRA interviewed senior securities counsel at the following firms: Blake, Cassels & Graydon LLP, Borden Ladner Gervais LLP, Fasken Martineau DuMoulin LLP, Groia & Company Lawyers, McCarthy Tétrault LLP, Ogilvy Renault, Torys LLP and WeirFoulds LLP.

[13] The investigation of Cartaway Resources Corporation is a good illustration of some of these difficulties. In that case, investigations were launched by the TSE, ASC, Alberta Stock Exchange, BCSC and Vancouver Stock Exchange.

[14] Differences among jurisdictions' enforcement powers are detailed in the Blueprint Paper at 55-8 and include differences in prohibited activities, investigation orders, powers to order production of documents for an investigation, powers to search and seize, confidentiality of investigations, reports to a minister and a minister's power to order an investigation, and rules and procedures for joint hearings. See also the charts in the Condon Study at 447-9.

Regional differences in enforcement also result from disparate enforcement budgets and levels of expertise among the regulators. Robert MacLellan, former chair of the Nova Scotia Securities Commission and former vice-chair of the CSA, notes in his submission that the disparity in enforcement resources diminishes investor protection, stating that if a "local regulator does not have the resources to ensure and enforce compliance, the investor's rights are 'rights' in name only".

From a compliance point of view the disparity in resources between the provinces means that the Atlantic Provinces have fewer personnel to monitor the industry and are slower to make legislative amendments to deal with emerging compliance problems. This encourages forum-shopping by fringe players in the industry.

Eddy & Downs
Fredericton, New Brunswick

* * *

We believe that inadequate enforcement is one of the most significant weaknesses of the current system. Enforcement resources are inefficiently allocated. Coordination difficulties can both impede investigations and result in a multiplicity of proceedings, leading to further inefficiencies and potential injustices to respondents. Investor protection suffers from a lack of uniformity. There is no legitimate reason why investors should have different protection depending on the province in which they happen to live.

Policy Development

Policy development in the current system is often criticized as being slow and fragmented. The CSA notes in the USL Blueprint Paper, "currently, it can take several years to amend all of the securities acts of Canada due to different legislative timetables".[15] It points to the Zimmerman amendments to the take-over bid rules, which recommended, among other things, that the minimum deposit period for a take-over bid be extended from 21 to 35 days and that there be the option to commence a bid by way of advertisement. Although these amendments were not controversial and were accepted by all jurisdictions, it took four years to implement them across the country.[16]

... the present fragmented system of securities regulation has proven to be utterly incapable of updating rules on a timely basis in a global marketplace characterized by rapid change.

Canadian Council of Chief Executives

In view of the delays associated with passing legislation, most provinces now have rule-making authority, which allows regulators to make rules in certain specified areas that have the force of law. Although faster than the legislative process, rule making is plagued by similar difficulties.

[15] Blueprint Paper at 5.

[16] Ibid.

The Crawford Report notes that it generally takes a minimum of 18 months to implement a CSA multilateral rule initiative.[17] National policies and rules cannot be developed and implemented quickly because 13 regulators must first agree on policy direction and then on specific requirements. Each jurisdiction must then conduct its own approval process, including comment periods. Some jurisdictions require ministerial approval. In certain instances a province will choose not to participate in the initiative, even after time has been spent trying to accommodate that province's interests. While the CSA's recent creation of the Policy Coordination Committee and establishment of a permanent secretariat are intended to speed up the policy development process, it is not clear that this will result in a material improvement, since a consensus must still be forged among 13 regulators.

> Our members feel despair when they look at the length of time that it takes for regulatory reform to be generated at the CSA level.
>
> *Prospectors and Developers Association of Canada*

Given the accelerating pace of changes in capital markets, regulators must be able to respond quickly to new challenges. There is concern that Canada's current system may not be able to respond effectively. Not only is the policy-making process slow, it may also compromise the quality of policy development. As Robert MacLellan notes in his submission:

> In recent years there has been a divergence in regulatory philosophy amongst the major jurisdiction regulators. This is particularly apparent in the BCSC initiative, the ASC proposals for separating junior market regulation from senior market regulation and the OSC's approach to the application of the Sarbanes-Oxley principles in Canada .... This conflict leads to compromise solutions, delays in finding solutions, a lack of predictability of solutions or, on occasion, no solution. This does not inspire the confidence in the marketplace that is fundamental to sound regulation.

Mr. MacLellan also makes the point that, as a result of Canada's fragmented system, regulators must expend considerable energy and resources developing constructs for dealing with one another – energy and resources that could be spent more profitably dealing with issues facing capital markets.

Similar frustrations with a policy development process based on harmonization through consensus are expressed in a submission by Edward Waitzer, a former chair of the OSC:

> While, historically, harmonization was seen as the solution to a fragmented system ... today it is generally viewed as a barrier to progress insofar as it leads to standards based on consensus, rather than what's right, it prevents more meaningful, deeper integration and, to the extent that less than 100% harmonization is achieved, it requires ongoing compromise (and detracts from public confidence in the integrity of the regulatory framework).

[17] Crawford Report at 76.

Canada's response to the U.S. Sarbanes-Oxley Act of 2002 illustrates this difficulty. After approximately one year of discussion and consideration, Canadian securities regulators[18] responded with three multilateral instruments that are scheduled to come into effect in early 2004.[19] Despite this effort, they failed to achieve consensus, as the BCSC has decided not to implement these rules.

In addition to the failure to achieve uniformity, some argue that Canada's response was too slow. Others argue that Canada's proposed approach, which exempts smaller companies from some of the more onerous governance requirements, is superior to the hastily enacted U.S. rules and was the product of a more collaborative and considered policy-making process.

A single regulator should also have the power to make regulation instead of relying on harmonized securities laws, which inevitably fall out of sync, or on time-consuming negotiation among the jurisdictions to achieve consensus.

TD Bank Financial Group

Without commenting on the merits of these arguments, it is clear that a well designed regulatory structure must provide regulators with the ability to move swiftly and credit them with the wisdom to move slowly, when appropriate. Canada's current regulatory system can move slowly, but cannot move swiftly.

Canada's decentralized securities regulatory structure also makes it more difficult than it should be to coordinate efforts with other important financial sector regulators such as the Office of the Superintendent of Financial Institutions (with its mandate to protect the safety and soundness of the financial system) and the Bank of Canada (with its supervisory and service role in respect of clearing systems). Many large securities firms are now integral parts of international financial institutions. Effective regulation increasingly depends upon information sharing and close collaboration among regulators within each country and internationally. Regulatory fragmentation and jurisdictional concerns can impede the necessary information sharing and collaborative action. This makes it more difficult to regulate financial institutions on a day-to-day basis and could severely impact Canada's ability to respond to a serious financial system shock.[20]

One further difficulty with the current system's policy responsiveness is the failure to capitalize effectively on shared knowledge across jurisdictions or to take advantage of existing regional expertise. Because of the fragmentation and duplication of the system, regulators with common expertise do not always cooperate on policy initiatives, resulting in poorer-quality regulation and less innovation.

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18 Canada's response to Sarbanes-Oxley involved a joint effort of provincial securities regulators, federal financial policy makers and national standard-setting organizations.

19 They are Multilateral Instrument 52-108 *Auditor Oversight*, Multilateral Instrument 52-109 *Certification of Disclosure in Companies' Annual and Interim Filings* and Multilateral Instrument 52-110 *Audit Committees*.

20 The United States established the President's Working Group on Financial Markets, which includes the Secretary of the Treasury and the chairs of the SEC, Federal Reserve and Commodity Futures Trading Commission. This group has collaborated on important policy initiatives, such as the Gramm-Leach-Bliley Act of 1999, which repealed key provisions of the Glass-Steagall Act of 1933 that separated banking, insurance and securities businesses. In Canada, the Senior Advisory Committee (SAC), chaired by the federal Deputy Minister of Finance, provides a forum for discussion among the Office of the Superintendent of Financial Institutions, Bank of Canada, Canadian Deposit Insurance Corporation and Financial Consumer Agency of Canada. Although other parties may be invited to participate, there is no single, permanent representative of Canada's capital markets that participates in the SAC.

Costs

Costs are imposed by the substantive content of regulations and the structure of the current regulatory system. There are increasing complaints that both are excessive. The CSA's 2002-2005 strategic plan notes that:

> The burden of regulation threatens the competitiveness of Canadian market participants. The regulatory burden is caused by: 1. Differences in regulatory requirements among jurisdictions 2. Separate decision-making processes in each jurisdiction 3. The volume and complexity of regulatory requirements.[21]

Our mandate is limited to recommending the best securities regulatory structure for Canada. Accordingly, our focus is on incremental costs attributable to the structure of Canada's regulatory system and not the content of the regulations themselves.

Our research identified three kinds of incremental cost: (i) costs of duplication in the regulatory structure, (ii) increased compliance costs for issuers and intermediaries and (iii) opportunity costs for issuers, intermediaries and investors resulting from missed market and investment opportunities. We will examine each in turn and then consider their cumulative impact on capital markets.

> It is critical that Canadian issuers and Canadian capital markets be competitive on a North American basis. Multiple securities jurisdictions, legislation and regulators serve to disadvantage Canadian capital markets by virtue of added costs and time delays.
>
> *Encana Corporation*
> *Calgary, Alberta*

Costs of Duplication

Thirteen different regulators incur 13 different sets of fixed and variable costs. Each regulator has separate staff and offices, with separate human resource departments, accounting departments and technology platforms. This duplication results in unnecessary costs and an inefficient allocation of resources.

In two studies, one commissioned by the IDA and another commissioned by the Committee, CRA measured the savings in commission operating budgets that would result if Canada had a single regulator.

CRA examined the relationship between 2002 commission operating budgets and market size, measured by GDP. Regression analysis was used to estimate the potential savings from consolidation. In performing its analysis, CRA assumed a single regulator with its head office in Ontario and regional offices located in each of British Columbia, Alberta, Manitoba, Quebec and Nova Scotia.[22]

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[21] CSA Strategic Plan 2002-2005.

[22] CRA Study at 509.

If the 13 regulators were consolidated into a single regulator in this way, CRA estimates total budgetary savings from rationalization of the existing regulatory structure to be $46.7 million, or 36.5%, of the $127.8 million total 2002 operating budgets.[23]

The discounted present value of these savings is almost one billion dollars.[24]

These savings would be even higher if the financial benefits from lower compliance and opportunity costs were included in the calculation. These are discussed in greater detail below.[25]

In sum, if Canada were to rationalize its securities regulatory structure it could have the same level of regulation at materially less cost, or much better regulation at the same cost.

Compliance Costs

We received numerous submissions from issuers and registrants expressing concerns about the excessive and unnecessary compliance costs imposed on them by the current system. Issuers and registrants bear increased compliance costs due to the multiplicity of securities regulators and divergent securities laws and administrative practices. They must be aware of the law in each of the jurisdictions in which they operate or contemplate operating.[26] They must also file forms with and pay fees to multiple regulators in connection with various transactions, incurring additional advisory costs in the process.[27]

Canadian listed companies consider the burden of regulatory overlap, duplication and fragmentation one of the biggest problems they face.

Canadian Chamber of Commerce

Three conspicuous examples of differences among provincial securities laws that increase compliance costs are the registration requirements, private placement exemptions, and rules restricting the resale of securities initially sold under a prospectus exemption. These three areas are of critical importance, since they govern who can deal in securities, how money can be raised privately and when securities purchased on an exempt basis may be resold.

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[23] Ibid at 511. Total annual cost savings found in the IDA Study were $40.1 million, somewhat lower than those in the CRA Study. The difference between the two studies is partially due to CRA's separation of data into enforcement and non-enforcement components in the CRA Study, and partially due to a somewhat different specification and different data. Ibid.

[24] Using a discount rate of 5%.

[25] CRA found that there would be additional savings if the single regulator operated on a cost-recovery basis, with total annual revenues equal to the single regulator's operating budget (IDA Study at vi). This assumption is reasonable. We believe that securities commissions should not be run as profit centres for provincial governments, as this would amount to a tax on capital market participants. In 2002, the 13 regulators collected a total of approximately $196.8 million in revenues, the vast majority of which were fees. Had revenues equaled the estimated operating budget of a single regulator of $81.1 million calculated above, total annual savings of $115.7 million could have been achieved by eliminating regulatory duplication and revenues not related to actual costs, representing the amount by which 2002 revenues exceed the estimated operating budget of a single regulator. This amount ($115.7 million) represents $69 million in annual savings over and above the $46.7 million in budgetary savings from rationalization of the existing regulatory structure on the basis described above. We note that this calculation does not take into account recent changes Ontario and Quebec made to their fee structures.

[26] As noted earlier, there are 25 national instruments and 24 national policies currently in force in Canada. However, there are still a significant number of local rules that only apply in one jurisdiction.

[27] The fee burden has been accounted for above and so will not be revisited here. We note, however, that there are additional administrative costs entailed in paying fees to multiple regulators.

The securities legislation of each of the provinces provides that no person shall trade securities, underwrite securities issuances or give advice with respect to securities investments unless the person is registered. In order to become a registrant, individuals or companies must file a registration application and pay a fee in each jurisdiction in which they wish to be registered. The substantive registration requirements differ among the provinces. Seven provinces require registration when a person or company trades in a security. Ontario and Newfoundland and Labrador have "universal registration" requirements that are more onerous, requiring a broader range of entities to register. Quebec requires registration when a person or company is carrying on business as a dealer or adviser.

> As a company required to be registered in jurisdictions in which we intend to do business, costs of the regulatory structure weigh heavily, not only as out-of-pocket expenses, but also in the commitment of time, energy and staff. The rules and terminology often vary among jurisdictions....
>
> *Greystone Managed Investments Inc.*
> *Regina, Saskatchewan*

In Canada, securities may only be issued pursuant to a prospectus or an exemption from the prospectus requirements. Private placements are issuances of securities on a prospectus-exempt basis. Despite their importance, the private placement exemptions are not harmonized. Seven provinces and two territories have adopted Multilateral Instrument 45-103 *Capital Raising Exemptions*. New Brunswick and the Yukon, which do not have rule-making authority, adopted MI 45-103 as a policy, meaning that an exemption application must be made on a case-by-case basis by each issuer seeking to use the exemptions contained in the instrument in those jurisdictions. In addition, there are numerous regional differences within the instrument itself.[28] Ontario has OSC Rule 45-501 *Exempt Distributions*, which has an "accredited investor" exemption that is similar but not identical to the "accredited investor" exemption in MI 45-103.[29] In Quebec, sales can be made under a prospectus exemption to "sophisticated purchasers" or under a $150,000 minimum acquisition prospectus exemption.[30]

> The exemption system is a mess. In order to meet the needs of issuers who may have only one purchaser in each of the four Atlantic Provinces, it is often necessary to navigate through the shoals of the subtle but real differences that distinguish the exemption rules in one province from those in another.
>
> *Eddy & Downs*
> *Fredericton, New Brunswick*

The resale rules are another instance in which there is considerable regional variation. Multilateral Instrument 45-102 *Resale of Securities* was an attempt to harmonize the resale rules. In addition to the fact that Quebec chose not to adopt these rules, there are fundamental differences among the participating

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[28] For example, mutual fund issuers are permitted to use the offering memorandum exemption in each of the participating jurisdictions, other than British Columbia and Nova Scotia.

[29] There are additional differences between the rules. OSC Rule 45-501 has a closely-held issuer exemption in addition to the accredited investor exemption, which permits an issuer to raise a lifetime total of $3 million in any number of financings as long as the issuer has no more than 35 shareholders, excluding employees and accredited investors. Instead of a closely-held issuer exemption, MI 45-103 has a private issuer exemption and a family, friends and business associates exemption. Furthermore, there is an offering memorandum exemption in MI 45-103 that has no analogue in Ontario.

[30] Quebec also has a private company exemption, an exemption for issuers with less than 5 security holders, a seed capital exemption and a tax shelter exemption.

jurisdictions, especially Manitoba, New Brunswick, Prince Edward Island and the Yukon. An example is the different resale restriction in British Columbia and Alberta for securities issued in connection with a take-over bid. In Alberta, the securities will be freely tradable upon issuance if the issuer has been a reporting issuer for 12 months or more. In the same circumstances the securities will be subject to a hold period in British Columbia. As Bennett Jones LLP notes in its submission, "these types of distinctions are not helpful and represent the type of outcome that is confusing to securityholders who find themselves on the wrong side of a provincial border".

> ... little of the data available to your Committee will make the point about the cost of internal compliance staff and legal and accounting counsel necessary to monitor and respond to up to thirteen securities regulators.
>
> *Investment Counsel Association of Canada*

There have been a number of attempts to quantify the compliance costs incurred by capital market participants due to the multiplicity of regulators. Through a survey of IDA members, CRA estimated the internal labour cost savings that IDA member firms would realize if Canada adopted a single regulator. It found that there would be compliance cost savings of 36.5% annually.[31] CRA also attempted to quantify these savings for issuers listed on the TSX and TSX Venture Exchange. It estimated total annual savings of approximately $14.2 million.[32]

The Burden on Emerging Companies

A particular issue that needs to be highlighted is the regulatory burden the current system places on small and emerging companies.

A research study commissioned by the Committee adopted a case study approach to determine incremental compliance costs associated with four types of transaction: dealer registration, initial public offerings, exempt financings and take-over bids. The research found that the incremental compliance costs for these transactions are generally not material for large issuers and registrants.[33]

By contrast, the research found that smaller issuers and registrants are less able to bear these costs and more likely to find them material, which could impose a competitive disadvantage on them.[34]

This is an important finding for Canada. One of the distinguishing features of Canada's economy is a vibrant capital market made up of thousands of small issuers. An infrastructure of dealers, accountants, lawyers and other advisors is in place to support them. Approximately 78% of Canadian public companies

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[31] CRA estimated the internal cost savings from reduced time and effort dedicated to registration, even after taking into account the impact of the NRD, to be 46% of the resources dedicated to registration, or $1.9 million, in annual savings. The internal labour cost savings from reduced time and effort dedicated to tracking regulatory charges are estimated to be 33%, or $3.7 million, annually. IDA Study at xiv.

[32] Ibid at 31. CRA noted that this estimate was not as robust as the estimate for intermediaries because the data for issuers were not as comprehensive.

[33] Materiality was defined as 0.5% of transaction value for capital costs and 1% of net profit for revenue costs. The study generally found that the actual incremental costs were well below this threshold. Costs Study at 527.

[34] Costs Study at 522-3.

have a market capitalization of less than $50 million, well below the cut-off for a U.S. micro-cap company.[35] The market for new public offerings in Canada is similarly focused on smaller companies. Between 1998 and 2003, 87% of new offerings of equities in Canada raised gross proceeds of less than US$50 million, more than twice the percentage in the same size category in the United States.[36]

Emerging public companies are critical to Canada's economy. Within this important segment of small issuers are the growth companies that may become the large capitalization stocks of the future. Canada's regulatory structure should be designed to provide them with the greatest opportunities to succeed. Ironically, the existing fragmented structure does precisely the opposite, as the burdens of our duplicative regulatory regime fall most heavily upon them. As Canaccord Capital Corporation states in its submission to the Committee:

> Within the international community, Canada should recognize that it is a small and medium-cap marketplace. Its approach should not be to try and replicate an approach that was created for the largest companies, pools of capital and industry participants in the world. Canada has an opportunity now to develop a specific niche within the international financial markets to become a leader in facilitating market access for small and mid-cap companies and access to venture capital for new and emerging enterprises. In this way, the international pools of capital available for these market sectors will be attracted to Canada and we will benefit from the enhanced economic activity that will result.

Time Delays and Opportunity Costs

The ability to raise capital on favourable terms is often very time sensitive, as intervening events can cause market "windows" to close. The current system can impose undue delays, which may result in missed market opportunities.

While the incremental direct costs of completing a transaction in all 13 jurisdictions may not be material for large issuers or registrants, the opportunity cost of a missed transaction can be extremely significant to an issuer of any size. The Costs Study found that the current system imposes significant incremental opportunity cost risk.[37]

Delays are inherent in the MRRS. When a long-form prospectus is filed under the MRRS, the principal regulator has 10 business days to provide comments. Once the comment letter is issued, a non-principal regulator has five business days in which to (i) raise concerns with the principal regulator that the principal regulator in turn passes on to the issuer, (ii) opt out of the system and deal directly with the issuer

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[35] Linda Hohol, President of the TSX Venture Exchange (Remarks delivered in Calgary, September 23, 2003). The cut-off for a U.S. micro-cap company is US$50 million.

[36] McKinsey & Company (Presentation to the Global Business Forum, Banff, September 26, 2003).

[37] See Costs Study at 521.

or (iii) indicate that it is clear to receive a final prospectus.[38] In addition to the potential five-business-day delay before a non-principal regulator decides which of the three options to pursue, each of (i) and (ii) can add further delays to the offering process, as the issuer will have to resolve an additional set of comments from a non-principal regulator. Although opt-outs are increasingly uncommon, they still occur from time to time.

The delay is potentially even greater when an issuer is seeking exemptive relief. Once a principal regulator has received an application for exemptive relief, it must send an acknowledgment to the non-principal regulators, who then have seven business days to comment.[39] After the seven-business-day period has elapsed, the principal regulator may circulate a draft decision document to the non-principal regulators, who then have another five business days in which to either confirm to the principal regulator that they have made the same decision or opt out of the system and deal directly with the applicant.[40]

Unequal Opportunities for Investors

An additional opportunity cost of the system's structure is that it denies investment opportunities to Canadians. A study by the Fraser Institute on prospectus-exempt rights offerings in 2000 and 2001 found that "investors in each territory and in provinces other than Alberta, BC and Ontario were excluded from the majority of offerings. Territories and smaller provinces such as PEI fared the worst".[41] The rules allow an issuer to bypass a jurisdiction in which less than 5% of affected shareholders are resident. The study concludes that the desire to avoid additional regulatory costs by filing in additional jurisdictions influenced issuers' decisions to bypass smaller jurisdictions. Similarly, investors in smaller provinces occasionally are denied the opportunity to invest in primary offerings because the issuer chooses not to file a prospectus in that jurisdiction.

> ... small issuers ... either find it costly to accommodate investors across provincial borders or simply exclude investors in some provinces.
>
> *Canadian Listed Company Association*

Newfoundland and Labrador's universal registration requirements also reduce investment opportunities for its residents. Given the small size of the province's capital market, intermediaries sometimes choose not to obtain and maintain a registration there, resulting in fewer investment options for investors.[42]

* * *

[38] National Policy 43-201 *Mutual Reliance Review System for Prospectuses and Annual Information Forms* (NP 43-201), section 5.2. When a short-form prospectus is filed the principal regulator has three business days to issue a comment letter and a non-principal regulator then has until noon, Eastern time, on the next business day to either (i) advise the principal regulator that it has concerns which, if unresolved, will cause it to opt out of the system or (ii) indicate it is clear to receive a final prospectus. NP 43-201, section 5.3.

[39] See National Policy 12-201 *Mutual Reliance Review System for Exemptive Relief Applications* (NP 12-201), sections 5.6 and 6.2. This period can be shortened in exceptional circumstances.

[40] NP 12-201, section 8.1.

[41] Neil Mohindra, "Investors Sanctioned for Living in PEI" (March 2002) Fraser Forum 32 at 32.

[42] See comment letter by Osler, Hoskin & Harcourt LLP to the Alberta Securities Commission on the CSA's USL Project (May 2, 2003).

Costs of duplication and opportunity costs are the most significant costs imposed by the existing regulatory system. Generally, compliance costs are not material for larger firms and transactions – a point made in a recent study commissioned by the CVMQ.[43] These costs, however, are more frequently material for emerging companies and intermediaries, who bear the greatest burden of Canada's fragmented regulatory system.

The cumulative effect of lost economies of scale, opportunity costs and compliance costs is significant and should be reduced. In addition these costs, when combined with the other weaknesses of the current system discussed in this chapter, result in an increased cost of capital for Canadian firms. While the precise increase may be difficult to quantify, any unnecessary increase in the cost of capital results in a competitive disadvantage that Canada cannot afford to bear.

International Perspectives

International perceptions of Canada's capital markets and its regulatory structure are important for establishing Canada as a preferred destination for capital.

The views of the many capital market participants that argue that Canada's international competitiveness suffers as a result of the current structure are well summarized in Canfor Corporation's submission:

> Canadian capital markets compete globally for issuer and investor participation. If it cannot compete and if it cannot offer an efficient and cost effective service, investors and issuers will seek out other markets and sources of capital .... The current regulatory framework does not provide an efficient, cost effective service which is competitive.

This view is also expressed by a number of large institutional investors and market intermediaries in the United States, who say that Canada is disadvantaged internationally because of its regulatory system.

A further weakness of the current system is the lack of a capital markets regulator that can speak for Canada with a national perspective in international dealings. Canada is the only major industrialized country without a national securities regulator. Instead, Canada is represented by four commissions. Ontario and Quebec are full members, while British Columbia and Alberta are associate members.

> In the international arena, it is important that there be a single contact point representing securities regulators in Canada.
>
> *Canaccord Capital Corporation*
> *Vancouver, British Columbia*

[43] Jean-Marc Suret and Cécile Carpentier, *Securities Regulation in Canada* (2003) at 168. The study found that compliance costs in Canada were not significant and that Canada's regulatory system is faster than the SEC in reviewing filings. We agree that compliance costs for the largest issuers and intermediaries are not generally material and that the Canadian system is faster than the U.S. system in certain respects. However, we note that the study did not discuss the impact of Canada's duplicative regulatory structure on small issuers or registrants, nor did it address the current system's inefficient allocation of resources. Moreover, while the Canadian system may be faster than that of the United States in clearing prospectuses, this conclusion does not address the unnecessary opportunity costs imposed by multiple regulators.

While foreign regulators told the Committee that they have high regard for the calibre of Canada's securities commissioners, who have made meaningful contributions on IOSCO committees, they also expressed concern about "who to call" when dealing with Canadian issues. Each of the Canadian regulators is charged with representing the interests of its province, but none has the explicit mandate to take a national perspective.

Our Assessment

There is a need and an opportunity to make significant improvements to our current regulatory structure to correct its flaws:

- Enforcement must be significantly improved. Insufficient resources are directed towards enforcement. Wrongdoers too frequently go unpunished, and adjudication is unduly delayed. Coordination difficulties impede investigations and can lead to multiple proceedings that are inefficient and unfair. There are disparate priorities and a lack of uniform investor protection. All of this undermines confidence in Canada's capital markets.
- Policy development is characterized by compromise and delay. Canada cannot respond as effectively or innovate as quickly as it should in the fast-changing global marketplace.
- The system is too costly. The multiplicity of regulators leads to an inefficient allocation of resources and unnecessary opportunity and compliance costs.
- Internationally, Canada's securities regulatory structure is recognized as being unnecessarily complex. No one is mandated to represent the national interest in dealing with international securities regulators and other policy makers.

These weaknesses make Canada less competitive than it must be at a time of increasing global competition. It's time to address them.

That [the current system] has worked as well as it has is a credit to the extensive efforts and cooperative spirit of the many regulatory authorities involved – but we can do better.

RBC Financial Group

CHAPTER four

Requirements of an Effective Regulatory Structure

We have concluded that our present regulatory structure fails to meet the current and anticipated needs of our capital markets. In designing a more effective structure, we considered the objectives of securities regulation and how those objectives are best achieved. We then developed criteria to evaluate the effectiveness of alternative regulatory models.

The Objectives of Securities Regulation

The fundamental objectives of securities regulation are to protect investors from unfair practices and to foster fair and efficient capital markets and confidence in those markets. Our terms of reference provide that the ideal structure should:

- provide sound protection for investors and confidence that Canada's capital markets are regulated with the highest standards and that those standards are rigorously and equally enforced throughout the country;
- provide efficient capital markets for Canadian businesses of all sizes, and not place an undue burden on firms seeking to raise capital or on firms seeking to offer capital market services;
- encourage dynamic and innovative capital markets throughout Canada; and
- present foreign investors, governments and regulators with a positive image of securities regulation in Canada.

Several submissions observe that the objectives of securities regulation should be viewed from the perspective of the users of the system, rather than the regulators. We considered the objectives of regulation from the point of view of three of the main users of capital markets: investors, issuers and financial intermediaries.

> Regulation needs to be looked at from the standpoint of the user, not the suppliers of regulation services. Investors, issuers and intermediaries want "one-stop shopping" for regulatory services.
>
> *Market Regulation Services Inc.*

CHAPTER

Investors require capital markets that are fair, transparent and liquid. They require access to information on a timely basis to ensure a level playing field and that investment gains and losses result from legitimate economic factors. They require effective enforcement to maintain investor confidence in the market and they require redress when they are aggrieved. Fair and transparent markets with effective enforcement inspire investor confidence, thereby attracting capital and increasing liquidity.

For Canada, liquid capital markets are crucial to economic development, and fragmented securities regulation inhibits liquidity.

Scotia Capital Inc.

Issuers have similar objectives. They require efficient access to capital that is more readily available in liquid markets. Liquidity will be impaired if there is a perception that capital markets are not fair and transparent. The adequacy of market policing is an important factor in this perception.

Issuers also benefit from regulation that is proportionate to the risks being addressed. Excessive regulation increases the cost of capital. Emerging companies, which constitute a critical component of Canada's economy, bear the greatest burden from excessive regulation. While securities regulation is a complex field, unnecessary complexity benefits neither investors nor issuers.

... it is important to note that while some regulations are necessary, a burdensome regulatory system ultimately defeats the efficiency and effectiveness of the market system ....

Imperial Oil Limited
Toronto, Ontario

The interests of financial intermediaries, including investment dealers, brokers, financial advisors and portfolio managers, are in line with those of issuers and investors. Submissions from financial intermediaries uniformly stated their need for a simple, efficient and responsive regulatory structure. Any incremental regulatory burden increases their cost of doing business, which is then passed on to investors and issuers. Intermediaries are frequently the source of new financial products and services. Accordingly, they require a regulatory system that is responsive to and facilitates innovation. Like investors and issuers, intermediaries also require effective enforcement to ensure fair competition and to maintain public trust in their industry and the markets in which they participate.

An effective enforcement regime should both punish wrongdoers and encourage compliance. An effective system of regulation depends heavily upon the voluntary efforts of capital market participants who are motivated by reputational concerns to act with integrity. Compliance is enhanced by a system of regulation that is clear and transparent and impeded by one that is overly complex.

The structure of securities regulation should be designed to facilitate the achievement of these objectives.

Criteria for Evaluation

Based on these objectives and our review of the strengths and weaknesses of the current system, submissions, consultations and research,[1] we developed a list of criteria to evaluate potential regulatory structures.

Effective Enforcement – The securities regulatory structure should enable prompt and effective enforcement action being taken against wrongdoers. It should facilitate an efficient allocation of enforcement resources, effective coordination with other enforcement agencies, appropriate development and deployment of specialized resources, and uniform enforcement priorities and investor protection.

Policy Innovation and Development – The securities regulatory structure should produce sound policy on a timely basis. It should encourage innovation to address current and anticipated market needs. It should reflect the national interest, while also taking regional needs into account.

Cost-effectiveness – The securities regulatory structure should allocate resources as efficiently as possible, eliminate unnecessary duplication, and minimize compliance and opportunity costs.

Responsiveness to the Needs of Emerging Companies – Recognizing that small and emerging companies are critical to Canada's economic growth, the securities regulatory structure must be responsive to their needs.

International Presence – Canada's securities regulatory structure should be perceived internationally to be world-leading. It should help make Canada a preferred destination for international capital and increase foreign investment opportunities for Canadian investors. It should provide for a securities regulator that can speak for Canada from a national perspective.

[1] See A. Douglas Harris, "Securities Regulatory Structure in Canada: The Way Forward" (2003) 38 Canadian Business Law Journal 57.

Responsiveness to Local and Regional Needs – The regulatory structure should provide a local presence to ensure effective enforcement, facilitate personal interaction with capital market participants and reflect regional needs in policy making.

Stability – The regulatory structure should have structural permanence. It should not allow jurisdictions to opt out of the system, either on a general basis or in respect of specific issues.

Equal Treatment for Investors – The regulatory structure should ensure that all Canadians have equal access to investment opportunities and equivalent redress if they are dealt with unfairly.

Accountability and Governance – The regulatory structure should ensure that regulators are accountable to both the Canadian public through their elected representatives and capital market participants for their performance. The regulatory structure should have exemplary governance.

Simplicity – The regulatory structure should not be unnecessarily complex or unduly increase the regulatory burden. The maintenance of the structure should not require a high degree of continuing regulatory attention and energy. It should encourage expeditious regulatory review of capital market transactions consistent with appropriate investor protection.

This list is not exhaustive and its application is not a simple process of addition since not all of the criteria are of equal weight. We have, however, found the criteria to be of assistance in evaluating alternative regulatory models in order to determine which best meets the needs of Canada's capital markets.

Models for Reform

Our terms of reference require us to consider the respective merits of two specific models, namely:

(a) an enhanced version of the present system, with such practical and achievable improvements as the Committee might propose so that there is a greater sense of common purpose and more efficiency; and

(b) a single commission model in which governments electing to participate would pool some or all of their authority in a single regulator administering one set of rules.

We believe these two models are best viewed as two distinct categories under which reform proposals can be classified. Under the category of enhanced versions of the present system, "passport models" have received the greatest amount of support.

In Chapter Five we consider whether a passport model can meet the needs of Canada's capital markets, taking into account the criteria for evaluation outlined above. In Chapter Six, we consider a single regulator model and recommend the one we believe would be best for Canada.

CHAPTER five

The Passport System

Passport models have recently attracted considerable attention. A steering committee of provincial ministers released a discussion paper in June 2003 setting out elements of a proposed passport system. The CSA's USL Project also contemplates the creation of a passport system. In addition, a number of capital market participants have expressed support for such a system.

In this chapter we consider key design features of a passport system. We then review two examples of existing passport systems, the European Union's regulatory structure and the Canada-U.S. Multijurisdictional Disclosure System (MJDS). Finally, we analyze the strengths and weaknesses of the passport model as it might be applied to Canadian securities regulation. We conclude that while a passport system, properly designed, would be a significant incremental improvement over Canada's existing regulatory structure, it fails to satisfy a number of important objectives and is not the best securities regulatory structure for Canada.

Overview

A passport regulatory model refers to a multijurisdictional regulatory regime in which regulated entities or products are subject to and need only comply with the rules and decisions of a single regulatory authority – the "primary regulator". Compliance with the rules and decisions of the primary regulator serves as a "passport" which permits the entry of the regulated entity or product into other participating jurisdictions. A Canadian passport model would (generally) subject capital market participants to the authority of a single provincial securities regulator, regardless of where they undertake capital markets activity in Canada.

In general there are three kinds of passport models: (i) a passport model in which participating jurisdictions have uniform rules (Uniform Passport),[1] (ii) a passport model in which participating jurisdictions may have different rules, provided they all adhere to common principles (Common Principles Passport)[2] and (iii) a regulatory competition model (Regulatory Competition Passport), which is a variant

[1] Supported by the CSA through the USL Project.

[2] The Chair of the BCSC has suggested that a passport system could be based on the Objectives and Principles for Securities Regulation developed by IOSCO. See Doug Hyndman, "Passport to Progress: How to Improve Canadian Securities Regulation" (Speech to the Economic Club of Toronto, September 17, 2003).

of the Common Principles Passport in which capital market participants choose their primary regulator.[3] Each of these models seeks to build on the existing regulatory structure. None of them calls for the creation of a new securities regulator or for fundamental institutional reform, as the existing regulatory infrastructure would generally stay intact under each of these models.

A passport system in Canada would likely be implemented through comprehensive inter-delegation of regulatory functions. Delegation is distinct from mutual reliance, which forms the basis of the Mutual Reliance Review System. Mutual reliance involves no surrender of jurisdiction by any securities regulatory authority.

For example under the MRRS non-principal regulators issue receipts for prospectuses in reliance on the review conducted by the principal regulator.[4] By contrast, under a delegation model, a delegating jurisdiction relinquishes regulatory authority and transfers it to another jurisdiction. In the case of prospectus review, only the primary regulator would issue a receipt. Proponents argue that a delegation model "could create a virtually seamless system of securities regulation which would allow 'one stop shopping' by industry participants".[5]

Elements of a Passport System

Scope

For a passport system to result in true "one stop shopping", its scope should be as broad as possible. The MRRS is limited primarily to prospectus clearance and exemptive relief applications. A broader passport system could entail delegation of virtually all regulatory functions, including prospectus clearance, exemptive relief applications, registration, continuous disclosure requirements, insider reporting, exempt financings, take-over bids, insider bids, related-party transactions, proxy solicitation, corporate governance requirements, compliance and enforcement.[6]

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3 Supported by a number of academics and market participants. The Provincial Ministers Discussion Paper considers both the Uniform Passport and Common Principles Passport but does not resolve the question of which to propose.

4 NP 43-201, section 7.6. While non-principal regulators each issue receipts, the principal regulator issues one MRRS decision document evidencing them.

5 Blueprint Paper at 5.

6 The USL contemplates delegation of "all regulatory functions". See Blueprint Paper at 10.

Extending the scope of a passport system to include enforcement poses design challenges. The Provincial Ministers Discussion Paper contemplates a divided approach to enforcement matters. It proposes that the primary regulator would have responsibility for investigation and enforcement action with respect to "market access rules" violations, such as breaches of prospectus disclosure rules or failure to comply with exempt financing requirements. Investor complaints would continue to be investigated and enforced by the regulatory authority and courts of the investor's jurisdiction, which would apply the local laws of that jurisdiction. The local regulator will often be better positioned than the primary regulator to receive and respond quickly and effectively to an investor's complaint, and there are limitations on the ability of the primary regulator to sanction conduct that takes place entirely in another jurisdiction. Where an investor complaint is related to market access rules, the regulator in the investor's home jurisdiction would refer the matter to the primary regulator and would only take enforcement action if dissatisfied with the actions of the primary regulator.[7]

The Primary Regulator

There are a number of bases upon which the primary regulator can be determined under a passport system. The Provincial Ministers Discussion Paper suggests that this determination could be based on the capital market participant's head office location – the same basis as the determination of a principal regulator under the MRRS.[8] While other models have been proposed, such as allowing issuers to choose their regulatory jurisdiction in the hope of stimulating regulatory competition, these models have not attracted significant support outside the academic community and we believe they have drawbacks, as discussed below.[9]

For non-resident entities, either one jurisdiction could be designated as the primary regulator for all non-residents, or non-residents could be given the right to choose their primary regulator.

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7 Provincial Ministers Discussion Paper at 11.

8 Ibid at 10. As under the MRRS, not every provincial commission will want to or have the capability to act as a primary regulator. Accordingly, a jurisdiction could choose to delegate its regulatory responsibilities to a regulator in another jurisdiction.

9 Our discussion of the merits of regulatory competition is in the section "Type of Harmonization".

Harmonization of Securities Laws

The viability of a passport model depends upon a high degree of harmonization of securities laws. The Provincial Ministers Discussion Paper is of the same view, noting that:

> If securities laws were not substantially harmonized, there would be greater potential for jurisdictions to decline to join or to withdraw from the passport framework because of dissatisfaction with the application of different laws.[10]

Stability is a central objective of any effective securities regulatory structure, and of particular relevance to a passport system. To achieve this objective, all jurisdictions must initially opt in to the passport system and the threat that any would opt out should be minimized. As noted in the Provincial Ministers Discussion Paper, harmonization of securities laws is key to this objective. If securities laws are harmonized, provinces would be more willing to opt into the system, and there would be less reason for them to opt out.[11]

It is important that a passport system include a mechanism for ensuring continued harmonization of securities laws. This mechanism requires the following elements: (i) agreement on the type of harmonization (i.e. uniform rules or common principles), (ii) a process or mechanism for evolving harmonized law to meet ongoing capital markets needs and (iii) constraints on the ability of jurisdictions to opt out of the system.

Type of Harmonization

A fundamental initial question is whether a Canadian passport system should be based on uniform rules (Uniform Passport) or common principles (Common Principles Passport). If based on common principles, a further question is whether capital market participants should be entitled to choose their primary regulator so as to foster regulatory competition (the Regulatory Competition Passport).

The CSA's USL Project effectively contemplates a Uniform Passport. According to the CSA, one of the USL's most significant policy initiatives is "the ability of a securities regulatory authority to delegate decision-making across all regulatory functions to another securities regulatory authority".[12] The USL with inter-delegation, if implemented, would be a passport model based on uniform rules.[13]

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[10] Provincial Ministers Discussion Paper at 9.

[11] In theory a passport system need not require harmonization of securities laws before being implemented. Practically speaking, however, it is highly unlikely that a passport system could be implemented in Canada without some degree of harmonization.

[12] Letter from the USL Project Steering Committee (January 30, 2003).

[13] The CSA agrees, noting that "The USL Project to develop uniform securities legislation for consideration by each of the provincial and territorial governments of Canada complements the Ministers' initiative to implement a passport system or one-stop shopping for issuers and registrants". CSA Notice 11-304 *Responses to Comments Received on Concept Proposal Blueprint for Uniform Securities Laws for Canada.*

A key advantage of a Uniform Passport over the other passport models is that it should result in greater stability. Both a Common Principles and a Regulatory Competition Passport would be less stable. This is because certain jurisdictions' application of the principles may prove unacceptable to other jurisdictions, leading them either to refuse to opt in or to opt out of the system at a later date (at least in respect of certain jurisdictions).

In addition, some commentators point to a risk, particularly under a Regulatory Competition Passport, of a "race-to-the-bottom" in which regulators would seek to attract regulatory customers to their jurisdictions by reducing the requirements imposed on regulated entities below the optimal level. There is considerable debate as to whether regulatory competition in corporate law leads to a "race-to-the-bottom" or rather a "race-to-the-top", since market participants do not wish to be associated with other than the highest standards. Any race-to-the-bottom would to some extent be constrained by the requirement that regulation adhere to common principles.

The disadvantages of a Regulatory Competition Passport are well stated in one of the submissions:

> A competitive model will perpetuate our complex and fragmented regulatory culture with a multiplicity of securities laws .... Competitive federalism would undoubtedly entrench regional sentiments .... [T]his model may pervert the fundamental mandate of securities regulation of pursuing the public interest and capital market integrity by focusing on the financial and economic implications of successful regulation. [14]

As an illustration of the lack of stability a Common Principles or a Regulatory Competition Passport could pose, consider the disagreement between securities regulators in Ontario and British Columbia over the BCSC's new regulatory proposals.[15] The BCSC proposals call for a reduction in the volume of regulation, in part through the adoption of a more "principles-based" approach to regulation as opposed to a prescriptive "rules-based" approach. The BCSC has suggested that a passport system based on adherence to common principles, such as the IOSCO Objectives and Principles of Securities Regulation (which the BCSC believes would accommodate its reform proposals), could be adopted quickly.[16] The OSC disagrees, claiming that aspects of the BCSC proposals "are not compatible with the direction of the CSA and other major international jurisdictions".[17] Given the OSC's reservations about the BCSC proposals, it is unclear whether Ontario would participate in a system that grants a passport based on compliance with BCSC regulation should British Columbia implement its own proposals.

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[14] Amy Lewtas submission to WPC.

[15] *Securities Regulation That Works – The BC Model: Draft Legislation* (2003) and *Commentary on Draft Legislation* (2003).

[16] By contrast, in the study on securities market regulation in the European Union commissioned by the Committee, the authors express the view that the IOSCO Objectives and Principles of Securities Regulation are not sufficient to ensure stability of a passport system, since they fail to prevent objections by host regulators arising from lacunae in harmonized standards. See EU Study at 112.

[17] Letter from David Brown (Chair of the OSC) to Doug Hyndman (Chair of the BCSC) (June 27, 2003).

We are of the view that a Uniform Passport would be preferable to a Common Principles or a Regulatory Competition Passport. The USL could form the basis of a Uniform Passport, with each jurisdiction adopting it as part of a package of legislation implementing the system. In addition, some degree of local and regional flexibility could be accommodated under a Uniform Passport through exceptions allowing limited local rules that could be developed in response to local needs.[18]

Policy Development Mechanism

For a passport system to work effectively, there must be a mechanism to develop uniform regulation on a timely and coordinated basis.[19]

The CSA recently announced the creation of the Policy Coordination Committee to improve the development of harmonized policy. To be an effective policy development mechanism in a passport system, the PCC (or a similar body) would need to be able to respond more quickly in the face of changing market conditions than regulators do at present. Currently, it takes a minimum of 18 months to implement a CSA multilateral rule initiative[20] – an unacceptably long period of time given the magnitude and rate of change in the current capital markets environment. Effective and timely policy development by the PCC would require a dedicated staff with appropriate expertise, regional representation and sufficient funding to achieve its mandate.[21]

While a properly structured PCC with the necessary resources could improve the speed at which policy is developed, the need to forge a consensus among multiple regulators would remain. To address this concern, participating jurisdictions could delegate policy-making responsibility to the PCC and agree to adopt the rules and regulations the PCC proposes. Since the PCC would not always be able to reach unanimous agreement on policy initiatives, a mechanism for resolving disagreements would have to be implemented in which a supermajority could make binding policy decisions.[22]

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18 Both the Provincial Ministers Discussion Paper and the Blueprint Paper contemplate the accommodation of local and regional needs. In the Provincial Ministers Discussion Paper, "acceptable departures" from harmonized standards would be subject to principles agreed upon in advance that would preserve the integrity of the passport system. Before adopting a local initiative, a province or territory would consider: whether the initiative was necessary to meet a policy objective; minimizing the impact on other jurisdictions; minimizing the impact on the efficiency of the passport framework; whether the measure would be restricted to a limited portion of the Canadian marketplace; and making the measure subject to regular sunset reviews. Local initiatives would be referred to the CSA for discussion to determine if they could be adopted nationally. See the Provincial Ministers Discussion Paper at 11.

19 Even if a Common Principles or a Regulatory Competition Passport were adopted, there would need to be some mechanism to determine whether controversial regulatory initiatives conformed to the common principles.

20 Crawford Report at 76.

21 The CSA's recently announced secretariat will include an executive director, policy coordinator and support staff. The secretariat would need significantly more staffing to be effective as the policy development mechanism for a Uniform Passport model.

22 As the EU Study notes, the European Union has increased its capacity for action by introducing supermajority voting, instead of unanimity, as the basis for adopting measures aimed at establishing a single internal market for financial services. See EU Study at 111.

Constraints on Opting Out

Significant constraints on opting out are essential to maintaining the stability of a passport system. A design weakness with the MRRS is that a regulator can opt out of the system at any time when it disagrees with the approach taken by the principal regulator. The decision to opt out can be made on a case-by-case basis, subject to approval by the chair or vice-chair of the regulator. We note, however, that opt-outs are now increasingly rare and commend the commissions on their cooperation in this regard.

More problematically, on the policy-making front, regulators are free to abandon (or threaten to abandon) CSA initiatives if they choose, which impedes timely policy development and gives jurisdictions leverage in demanding compromise solutions.

Reciprocal delegation can result in greater stability. As noted above, unlike the MRRS, delegation entails the relinquishment of regulatory authority by the delegating jurisdiction to the delegated jurisdiction. While delegation is an improvement over mutual reliance, in order to ensure maximum stability, delegation should be difficult to revoke, within constitutional limits.

The USL contemplates optional delegation by regulators pursuant to agreements that would be capable of revocation at any time at the option of either the delegating or the delegated authority.[23] To ensure greater stability, the legislation could provide that a jurisdiction could only opt out of the system if the decision was made by either a provincial cabinet or the relevant minister, in either case after consultation with the chair of the jurisdiction's securities commission.[24]

Accountability and Governance

Under a passport system regulators would remain accountable to the public at large for securities regulation in their respective jurisdictions, as is the case today under the existing regulatory structure.

Existing Passport Systems

Some lessons regarding the design and implementation of a Canadian passport system can be drawn from the European Union's securities regulatory structure and the Canada-U.S. Multijurisdictional Disclosure System, two existing passport systems.

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[23] Blueprint Paper at 10.

[24] An even greater disincentive to opting out would be if the delegation were implemented by statute, which would in turn require new legislation to revoke it.

The European Union Passport System

The European Union's experience with a passport system in its capital markets has been fraught with difficulties. An enormous investment of time and resources has been necessary to create the EU system. Although the system's functioning has improved in recent years, it is still complex and slow.

It is instructive to consider how the European Commission approached an effective harmonization framework. Its approach has changed over time. From the 1960s to the mid-1980s, the Commission and member states worked towards extensive harmonization, but these efforts were "extremely slow and ineffective".[25] Beginning in the mid-1980s, the Commission changed its approach to one based on minimal harmonization and mutual recognition. As the authors of the EU Study note, "by the mid-1990s it became apparent that the new approach had not delivered sufficiently in the different areas of financial services, as significant obstacles to the provision of cross-border financial services remained, particularly in the area of securities markets".[26] Most recently, on the basis of the recommendations of the Lamfalussy Report, the pendulum has swung back to greater harmonization.

The European Union has introduced a complex policy-making process for developing harmonized law based on the Lamfalussy Report's recommendations. The "Lamfalussy procedure" is a four-level legislative process in which securities policies are developed by the European Commission, a number of specialized committees and national regulators.[27] While it has improved the policy development process, it still takes a great deal of time to make and implement policy directives. For example, the EU Directive on Prospectuses was adopted in July 2003 after almost three years of work and will not be implemented before 2005. The effectiveness of the Lamfalussy procedure remains to be fully proven.

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[25] EU Study at 107.

[26] Ibid.

[27] The four levels of the Lamfalussy procedure are described in the EU Study as follows at 123 (emphasis in original):

1. Broad framework principles for legislation (so-called level 1 legislation) are agreed at the EU level. The Commission, after consulting widely, makes a legislative proposal to the Council and the Parliament using co-decision procedures. In order to speed up the adoption, existing fast-track procedures are used if possible. In addition the preferred instrument should be regulations, i.e. a legislative act that is binding in its entirety and directly applicable in all member states, rather than directives, which can take up to 18 months for national authorities to implement.
2. The detailed rules (so-called level 2 legislation) how to implement the principles are developed at the EU level via the use of so-called comitology procedures. Under this procedure, the Council delegates the power to execute EU legislation to the Commission. Representatives of the member states assist the Commission by participating in "comitology" committees. The European Parliament has little direct influence and is more an external supervisor.
3. Enhanced and strengthened co-operation and networking between national regulators ensures that implementation of Community law at member state level becomes more consistent (level 3).
4. More attention is devoted to the enforcement of Community law. This is essentially the task of the Commission, but member states and their regulators should enhance their co-operation as well (level 4).

The European Court of Justice (ECJ) plays an important role in ensuring the stability of the system. In particular, the ECJ has jurisdiction over member states of the European Union and can order fines and other penalties against members that do not implement EU measures. In addition, securities regulation constitutes only one aspect of the EU's internal market. Accordingly, there is an incentive to cooperate with EU measures relating to securities regulation, or else sanctions in other areas may be imposed.[28]

A Canadian passport system need not involve the same degree of complexity as the EU system. There is far greater uniformity in securities laws and legal systems among the 13 provinces and territories than among members of the European Union, which should make the policy development process less arduous. That said, a key lesson from a review of the EU system is that implementing an effective passport model – and a policy development mechanism in particular – is not as straightforward as some might suggest. In addition, one advantage the EU system has over any passport system that might be introduced in Canada is the credible threat of sanctioning non-compliant jurisdictions through the ECJ. There is no comparable supra-provincial enforcement body in Canada.

Canada-U.S. Multijurisdictional Disclosure System

The MJDS, adopted by provincial regulators and the SEC in 1991 as a mutual recognition model, has worked well to reduce duplicative regulation and facilitate cross-border public financings and merger and acquisition transactions. It allows eligible Canadian issuers to make registered public offerings in the United States using a prospectus prepared and reviewed by Canadian securities regulators in accordance with Canadian requirements and to comply with U.S. continuous disclosure requirements by filing Canadian disclosure documents with the SEC. Filings made in accordance with the MJDS registration forms are not reviewed by the SEC unless the SEC believes there is a problem with the filing. The MJDS also provides that the filing of Canadian take-over bid and other merger and acquisition transaction documents is deemed to satisfy SEC requirements. The Canadian provisions provide U.S. issuers with reciprocal treatment in Canada.

The MJDS is regarded as a major success by large Canadian issuers. It was widely hailed in their submissions. Several issuers urged that any reforms to the Canadian securities regulatory structure should support its continuation. The MJDS has been used much less frequently by U.S. issuers to access the Canadian markets. While it works very well in facilitating cross-border public financings and merger and acquisition transactions, it is generally available only to larger issuers and those with established public reporting histories.

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[28] In addition to the importance of European Commission enforcement set out in level four of the Lamfalussy procedure, the Lamfalussy Committee has attempted to bolster enforcement against neglect or breach by member states in two respects. First, the Lamfalussy Committee accords considerable weight to "peer pressure" among member states. Since the Lamfalussy procedure calls for regular meetings of the Committee of European Securities Regulators, regulators that are not complying with EU directives will be subject to criticism from their peers. Second, the Lamfalussy Committee established an "Inter-Institutional Monitoring Group" that is charged with examining whether the recommendations of the Lamfalussy Committee are being properly enacted. See EU Study at 116.

The MJDS is a passport system that has worked well for its specific purpose of facilitating cross-border transactions for large Canadian issuers. It is important to note, however, that the scope of the MJDS is narrower than the scope of the proposed passport system. It does not address key issues such as coordination of policy making and enforcement, which are important components of a comprehensive securities regulatory system.

As we have observed, there have been many changes in capital markets and a significant increase in cross-border capital flows over the period since the adoption of the MJDS. This period has seen significant reforms in U.S. securities regulation, including in respect of foreign issuer access to U.S. capital markets. In the current environment, the United States seems less inclined to exempt foreign issuers from compliance with new U.S. regulatory standards. We believe it to be very important that Canada continue to improve its securities regulatory system so the SEC will maintain the necessary confidence in Canadian securities laws and their administration to continue the MJDS.

> ... it is crucial that changes in the regulatory structure not jeopardize the [MJDS], which currently enables Canadian issuers to access U.S. capital markets with considerably less inconvenience and cost than would otherwise be the case.
>
> *Canadian Pacific Railway*
> *Calgary, Alberta*

Strengths of the Passport System

A passport system would constitute a significant incremental improvement over the status quo.

Single regulator contact. A comprehensive passport system would generally[29] enable capital market participants to deal with only one regulator administering one set of laws. Duplicative compliance procedures and the need to track regulatory changes in multiple jurisdictions would be significantly reduced. Market participants would not have to wait for opt-out periods under the MRRS to expire or spend time dealing with multiple regulators on matters such as prospectus clearance and exemptive relief applications. The time required to review transactional documentation should be reduced, thereby reducing the risk of missing market windows.

> The opportunity for Issuers ... to deal with a single regulator ... [in a passport system] would significantly streamline the process and deliver tangible economic benefits.
>
> *Discovery Capital Corporation*
> *Vancouver, British Columbia*

A passport system would improve access to Canada's capital markets for non-residents as they would only be required to comply with one set of rules and deal with one regulator. This should result in increased foreign investment opportunities for Canadian investors.

Benefits of local presence. The passport system would preserve the current system's strength in addressing local and regional needs. Since the passport system would maintain the existing regulatory

[29] Enforcement matters may require capital market participants to deal with more than one jurisdiction.

infrastructure, there would continue to be a local regulatory presence and development of industry sectoral expertise. The ability of jurisdictions to pass local rules would also ensure that distinctive local issues could be addressed.

Relative ease of transition. A passport system could also be implemented relatively quickly and without significant cost. It would build on the base of the existing regulators, so transitioning to the new system should not prove very disruptive. The USL Project is well underway and could serve as a basis for harmonized law. A key transitional challenge, however, lies in designing and implementing a policy development mechanism capable of generating and implementing policy on a timely basis.

Weaknesses of the Passport System

We are of the view that even the best passport system has significant weaknesses and does not go far enough to meet the needs of Canada's capital markets.

The passport system does not significantly improve enforcement. A passport system lacks central coordination of enforcement activities. Consequently, divergent enforcement priorities for investors across Canada would persist. Smaller jurisdictions with lower enforcement budgets would not enjoy the equalizing benefits of centralization. Limitations on the ability of regulators to sanction conduct that took place in another jurisdiction would remain. In addition, there would also be little improvement in exploiting existing regional expertise in investigating and prosecuting particular types of offences nationally.

Since there would be no rationalization of the number of securities regulators under a passport system, there would continue to be an inefficient allocation of enforcement resources. Rationalization of the current system could lead to considerable annual budgetary savings. These savings could be spent on enforcement, improving its quality and bringing Canada's proportionate enforcement spending more in line with the United States.

A passport system should reduce the pressures for multiple regulators to investigate and institute enforcement proceedings in respect of any single matter. Nevertheless, because investors would have the right to complain in, and have complaints addressed by, the investor's home jurisdiction, the spectre of multiple proceedings would continue to exist. Capital market participants that operate interprovincially would therefore need to be familiar with and have the capacity to deal with the rules in all jurisdictions, to the extent that they differed.

The passport system does not sufficiently improve policy development. There would not be an appreciable improvement in the speed of policy making under a Uniform Passport. It would still be necessary to forge a consensus among multiple regulators to make policy. While the PCC could be designed to develop policy on a majority or supermajority basis, it is unclear whether the provinces would find this acceptable. Even if this were acceptable, if a large jurisdiction were unhappy with an initiative, the PCC might nevertheless seek uniformity in order to avert the possibility of that jurisdiction opting out of the system. This could impede the speed and effectiveness of policy making in addressing current and anticipated market conditions.

We share the concern expressed by former OSC chair Ed Waitzer in his submission that policy making by committee may lead to "standards based on consensus, rather than what's right". Finally, we believe that there is a compelling need for a capital markets regulator that can develop policy with a view to Canada's national interest.

> ...[a passport system] is clearly a second-best model, where many of the current system's cost and operational inefficiencies are retained, and many of the advantages of a single regulator would be unrealized.
>
> *Scotia Capital Inc.*

The passport system does not sufficiently enhance Canada's international capital markets credibility. The international perception of Canada's securities regulatory structure is important to Canadian issuers seeking to attract foreign capital. It is doubtful that the passport system would improve international confidence in the quality of Canada's securities regulatory system. International capital market participants would still view Canada as having an unnecessarily complex system of 13 regulators, particularly for a country with less than 3% of the world's capital markets and a population roughly equal to the state of California. Nor does the passport system create a single regulator charged with representing Canada's interests abroad.

The passport system risks instability. While various features can be designed to reduce the likelihood of opting out, nothing could completely prevent it. Each jurisdiction would retain the right to opt out of the passport system at any time. Even if jurisdictions never opted out, the threat of doing so could be used as leverage in negotiations among the regulators, which could distort the policy-making process.

The passport system does not maximize potential cost savings and efficiencies. It would still be necessary to continue to fund the operating budgets of 13 regulators and the CSA. Both the provincial ministers' passport proposal and the CSA's USL Project would continue to require issuers and registrants to pay fees to multiple regulators, even though only one regulator would be responsible for oversight.

The passport system does not improve governance and accountability. Under a passport system accountability is fragmented, with no single government or regulator accountable in respect of regulating Canada's national capital markets. While a provincial minister would be responsible to his or her citizens for securities regulation, if a rule or administrative practice were unpopular, each minister might argue that it was imposed upon the province by the PCC or other provincial jurisdictions. Similarly, there would be no direct accountability of a primary regulator to residents of other jurisdictions.

Conclusion

Although a comprehensive passport system would be a significant incremental improvement over the current system, it is not the best securities regulatory structure for Canada. We can, and should, do better.

CHAPTER SIX

A Securities Commission for Canada

The substantial majority of capital market participants are calling for the creation of a single regulator. We agree that a single regulator administering a single law would be the best securities regulatory structure for Canada. In this chapter, we describe the design of our recommended model. We demonstrate that this model is superior to the passport system and best achieves the objectives of an ideal securities regulatory structure. We also consider transitional issues that would need to be addressed in a move from the current system to a single regulator.

A Collaborative Architecture

The best securities regulatory structure involves a collaborative approach on the part of the federal and provincial governments. Both the federal government and the provincial governments would have significant roles. The federal role reflects the national and international nature of Canada's capital markets. The provinces would play a key role in the selection of the Commissioners and have initial and continuing input into the legislation. This would ensure that Canada retains the accumulated experience of the provinces in securities regulation. It would also ensure that the Canadian securities regulatory system would continue to be administered in a way that is regionally responsive to investors and issuers across Canada. The model provides for continued federal-provincial consultation in the evolution of Canada's securities regulatory system.

Our Recommended Structure

The essential framework of the structure we recommend is as follows:

- The federal government should enact a new Canadian Securities Act that would provide a comprehensive scheme of capital markets regulation for Canada. The Act should take into account the USL being developed by the CSA, and other provincial legislative reform proposals.
- Amendments to the legislation would not be implemented if a majority of the provinces representing a majority of the population of Canada objected.
- The Canadian Securities Act would be administered by a single Canadian Securities Commission consisting of nine full-time, regionally representative Commissioners, with two Commissioners from each of Ontario and Quebec, one Commissioner from each of British Columbia and Alberta, and two Commissioners from the remaining provinces and territories. There should be no regional restriction on the ninth Commissioner.

- The mandate of the Commission should reflect the objectives of securities regulation, in particular the need to foster fair and efficient capital markets. In order to provide a framework for enhanced accountability, the mandate should also explicitly obligate the Commission to operate in a way that fosters both regulatory innovation and dynamic capital markets and that recognizes the unique characteristics of Canadian capital markets.

- The Commissioners would be appointed by the federal Minister of Finance from nominees proposed by a Nominating Committee. The Nominating Committee would consist of ten members designated by the provinces (one from each) and three members (representing investors, registrants and issuers respectively) designated by the Minister of Finance.

- A Securities Policy Ministerial Committee should be established. It would consist of the ministers responsible for securities regulation in each province and the federal Minister of Finance and would provide a forum for policy and administrative input under the new system.

- The structure would ensure responsiveness to the needs of Canada's capital markets, the optimal use of existing expertise and excellent on-the-ground service delivery by the Commission. Specifically:

    - The Commission's head office, located in the National Capital Region, would be responsible for policy development, the coordination of regional and district office activity, dealings with other Canadian financial sector regulators, and international matters.

    - There would be strong, functionally empowered regional offices in Vancouver, Calgary, Winnipeg, Toronto, Montreal and Halifax. The regional offices would review prospectuses and registration applications, grant exemptions, conduct compliance reviews and investigations, and initiate enforcement proceedings, as well as contribute to policy development. Where warranted, there should be additional district offices to ensure effective and consistent issuer and investor treatment across Canada.

    - Capital markets advisory committees that are representative of issuers (large and small) and investors should be established to provide knowledgeable stakeholder input to the Commission. There would be regional representation on these committees.

- There would be guaranteed service levels, both nationally and at a regional level.
- There would be mechanisms to ensure accountability both to the Canadian public and to capital market participants.
- Adjudication would be the responsibility of a separate body independent of the Commission.

A Single Regulator for Canada

A single regulator structure is simple and clear, providing a single point of contact for capital market participants. It would enable a coordinated approach to enforcement, ensure that regulatory resources are optimally allocated, facilitate coordination with other law enforcement agencies and provide for uniform investor protection across Canada. It would facilitate better and, when required, more timely policy making. It would allow for a more efficient allocation of resources, and eliminate incremental compliance and opportunity costs. A single regulator would enhance the "brand" of Canada's securities regulation internationally.

> ... there should be only one Canadian securities regulator, administering and enforcing only one set of Canadian securities laws and regulations. We believe that this approach will allow for truly competitive and well-regulated capital markets in Canada.
>
> *Ontario Teachers' Pension Plan*
> *Toronto, Ontario*

A Single Code for Canadian Capital Markets

We believe that Canada would benefit from a single securities law and a single set of rules covering all securities regulatory matters in Canada. This would simplify compliance and reduce related costs. It would ensure consistent protection for investors across the country. It would provide a sharper focus for Canada's international capital markets dealings. Finally, it would provide a better framework for future amendments to address rapid changes in capital markets.

We considered a dual structure, in which securities matters limited to a single province would be regulated provincially, while interprovincial and international matters would be regulated by a national body. Given the nationally integrated nature of Canada's capital markets and the history of provincial regulation of securities matters with incidental effect on matters outside the regulating province, we

believe it would be difficult to draw a line with certainty as to which matters would be regulated nationally and which provincially. The potential for overlap would add uncertainty as well as unnecessary duplication and complexity. As a result we conclude that efficient capital markets require that the federal legislation extend to all matters related to securities regulation.

We believe the provinces have a substantial contribution to make with respect to the content of the legislation. The federal government should capitalize on the work of the CSA in developing the USL and on other provincial legislative reform proposals.

We propose that the federal government have an obligation to consult with the provinces before amending the legislation. Provincial input is important to ensure that any changes fully recognize regional interests. To that end, the Committee believes that amendments to the legislation should not be implemented if a majority of the provinces representing a majority of the population of Canada object.[1]

Mandate of the Commission

It is important that the statutory mandate of the Commission comprehensively address the needs and expectations of all stakeholders in Canada's capital markets. As a starting point, it should include reference to the fundamental objectives of regulation, namely, the protection of investors and the fostering of fair and efficient capital markets and confidence in those markets.

In order to provide an improved framework for accountability, we believe that the mandate should also direct the Commission to operate in a way that recognizes the unique characteristics of Canada's capital markets, particularly the preponderance of small companies and their significance to the capital markets and the economy, and the importance for many Canadian issuers of gaining access to international capital markets. We believe it to be particularly important to signal in the mandate that the Commission should endeavour to foster both regulatory innovation and dynamic capital markets and that the regulatory burden should be no more than that required to achieve regulatory objectives.

The mandate should be framed in such a way as to provide a mission statement for the new Commission.

The Securities Policy Ministerial Committee

We recommend the creation of a Securities Policy Ministerial Committee consisting of the provincial ministers responsible for securities regulation and the federal Minister of Finance. The Ministerial Committee would provide a framework for input by the provinces in both the formulation of securities policy and the ongoing administration of the system. It would provide a forum to discuss issues of importance to Canada's capital markets and ensure that regional perspectives and innovative ideas are

[1] The provincial right of veto would not apply to rules or policies made by the Commission.

brought forward. In particular, it would consider proposed legislative amendments and determine whether they were acceptable within the framework described above. The Ministerial Committee would also review the performance of the Commission against its service delivery guarantees.

We would expect that the Ministerial Committee would ensure that Canadian securities policy and its administration are conducive to the growth of Canada's critically important emerging companies.

The Nominating Committee

It is important that the Commissioners have the confidence of the provinces and of capital market participants throughout Canada. We believe that a process in which the provinces play a prominent role in the appointment of Commissioners and in which consideration is given to the perspectives of capital market participants can best achieve this goal.

Accordingly, we recommend that there be a Nominating Committee consisting of 10 members representative of the provinces (one appointed by each provincial government) together with three individuals appointed by the federal Minister of Finance to represent each of the issuer, registrant and investor stakeholder communities. After consultation with the Nominating Committee, the Minister of Finance would appoint one of its members as Chair. The design of the Nominating Committee would ensure that the Commissioners are acceptable to the provinces. We believe that the input of the members of the three capital market stakeholder groups in the nominating process is particularly important and would contribute to the selection of high-quality candidates.

In proposing a nominating committee of this nature, we took particular note of the structure of the Canada Pension Plan Investment Board (CPPIB), a joint federal-provincial initiative. Pursuant to the *Canada Pension Plan Investment Board Act* (CPPIB Act), the Governor in Council appoints directors on the recommendation of the federal Minister of Finance. A joint federal-provincial nominating committee prepares a list of nominees for the Minister of Finance's consideration. The Minister of Finance must consider recommending regionally representative directors with appropriate qualifications and experience. In addition, the CPPIB Act cannot be amended without provincial cooperation.

The CPPIB structure has provided a framework within which high-quality candidates have emerged through an appointment process in which provinces have been key participants. In the result, national goals have been achieved through intergovernmental collaboration. We believe that the nominating committee process we have outlined should assure the same responsiveness to regional and other capital markets considerations in the important task of selecting the Commissioners.

Composition of the Commission

We recommend that the Commission have nine full-time Commissioners.

The federal Minister of Finance would appoint the Commissioners from a list of nominees submitted by the Nominating Committee. The legislation would require that all Commissioners have demonstrated capital markets expertise or other relevant qualifications. While Commissioners would come from different provinces, their role would be to act in the national interest. The Minister of Finance would have the right to request that the Nominating Committee present additional nominees.

[The] national regulatory body... should not be dominated by any one region or group of industry participants.

Canaccord Capital Corporation
Vancouver, British Columbia

To gain the benefit of regional perspectives, we recommend that the Minister of Finance appoint two Commissioners from each of Ontario and Quebec, one Commissioner from each of British Columbia and Alberta, and two Commissioners from the remaining provinces and territories. There should be no regional restriction on the ninth Commissioner.

We propose that the Chair of the Commission be selected by the Minister of Finance from among the Commissioners after consultation with the Nominating Committee. The Chair would preside over the Commission and would be its principal spokesperson. Commissioners, including the Chair, would serve for a five-year term subject to a maximum of two terms, in order to ensure a framework for renewal and a fresh approach to issues. Some initial terms should be for less than five years to permit staggered appointments, so the entire slate of Commissioners need not be reviewed or replaced at the same time, thereby ensuring continuity.

Accountability and Governance of the Commission

At a time when issues of corporate governance and accountability have attracted unprecedented attention, it is important that the Commission be subject to high standards of governance and accountability.

The Committee believes that the Commission should be accountable to both the public at large through its elected representatives and to capital market participants through advisory panels and service standards.

Modern securities regulatory regimes have stronger mechanisms for input by, and accountability to, both the public and capital market participants than has historically been the case in Canadian securities regulation. Policy makers responsible for the design of regulatory structures are increasingly making use of service standards and advisory boards in their accountability structures. The Australian Securities and Investment Commission and the Financial Services Authority are both under an obligation to set annual service-level standards and include an assessment of their performance in their annual reports.

Australia's model is particularly noteworthy. Australia had a decentralized system of securities regulation similar to Canada's until the 1990s. In the wake of corporate scandals, power to administer the securities regulations of the eight Australian states and territories was conferred on the ASIC, a regulatory agency established by the Australian federal government that became Australia's sole securities and market conduct regulator. A key concern of the states and territories was that service levels might suffer with the shift to a single regulator. Accordingly, the arrangements creating the new regime required the ASIC to "maintain" service-level indicators equivalent "to the levels of service in each referring State and the Northern Territory, and ... monitor and report to each relevant State or Territory Minister on the performance of the Commission against the indicators in the Minister's State or Territory".[2]

Both the ASIC and the FSA have constituted independent advisory panels to ensure input into regulatory practices by those who participate in the markets. Australia has a "Consumer Advisory Panel" that was created to permit the national regulator "to liaise more effectively with the community of consumers of financial products".[3] The FSA consults with three panels: the Financial Services Consumer Panel, which provides a consumer perspective on regulation; the Financial Services Practitioner Panel, consisting of senior representatives of regulated institutions and market users; and the Small Business Practitioner Panel, whose members are drawn from small financial services firms. They are supported by small secretariats provided by the FSA and give feedback to the FSA on existing and proposed policy initiatives, as well as the FSA's general performance. The Financial Services Consumer Panel and the Financial Services Practitioner Panel also make formal policy proposals to the FSA, and, should the FSA disagree with a panel proposal, it must provide a written statement of its reasons, which are later published in the FSA's annual report.

We believe that accountability would be improved if practices of this nature were adopted in Canada.

In order to ensure accountability to the public, the Commission would be responsible to Parliament through the Minister of Finance. The Commission would prepare an annual budget and operating plan setting out its main objectives for the coming year and describing performance targets for service levels. The Ministerial Committee would review the annual budget and operating plan. This review would provide a forum for input on an ongoing basis.

The Commission would produce an annual report to be tabled in Parliament by the Minister of Finance. Concurrently, the Commission would deliver its annual report to the Ministerial Committee. The annual report would, among other things, provide a form of self-assessment of the Commission's performance relative to its budget, objectives and targets for the previous year and relative to its service delivery standards.

These measures, in particular the establishment of service delivery standards, would also ensure accountability to capital market participants. To further increase accountability to capital market participants, we believe that the Commission should avail itself of advice from expert advisory panels,

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[2] Corporations Agreement 2002, art. 603(2).

[3] Australia Study at 168.

expanding on the use of these panels by regulators under the present system. We make no specific recommendation as to the design, composition and number of the Commission's advisory panels. As a general matter, though, we believe that these panels should reflect Canada's regional diversity, and that representatives of small and medium enterprises should constitute a separate panel, given their importance to Canada's economy and the fact that they bear a greater burden of the costs of regulation in proportion to their size. We believe that advisory panels would be an important source of innovative ideas for regulators and would ensure that the needs of capital market participants are reflected in policy making.

Commission Offices

The head office would be responsible for policy development, the coordination of regional and district office activity, and international issues. Strong regional offices should consist largely of staff from existing provincial regulators to ensure the continuity of existing regulatory expertise. Where there is sufficient demand, district offices should be established to ensure that investors across Canada have adequate access to the Commission.

Head Office

The head office would be primarily responsible for making rules and policies and setting enforcement priorities, with input from the regional offices. All international dealings and coordination with other federal and provincial financial sector regulators would be handled by the head office, as would the regulation of exchanges and SROs.

An important role of the head office would be coordinating the activity of the regional offices to ensure an efficient allocation of resources, the sharing of expertise and consistency in approach. For example, the review of prospectuses might be assigned to a regional office with industry sectoral expertise. Similarly, staffing for investigations or prosecutions would be determined with reference to existing expertise, as well as other factors such as the relative capacity of the different offices. The head office would also ensure that enforcement is coordinated and that there is effective cooperation between the Commission and law enforcement agencies.

We recommend that the Commission's head office be located in the National Capital Region. The National Capital Region offers close proximity to other key financial policy-making and regulatory bodies such as the Bank of Canada and the Office of the Superintendent of Financial Institutions. It is accessible to key capital markets as well as to the rest of Canada and international centres. It has a skilled, bilingual workforce. It would underscore the Commission's duty to serve the national interest. It should engender support from capital market participants who have expressed serious concerns about a single regulator being dominated by any existing provincial securities commission.

Regional Presence

Regional offices should be established in Vancouver, Calgary, Winnipeg, Toronto, Montreal and Halifax. The regional offices would continue to do much of the same operational work as the commissions that are currently headquartered in those cities, with the critical difference being that these operations would be coordinated by the head office, in order, among other things, to achieve an efficient allocation of resources.

Regional offices would review prospectuses and registration applications, grant exemptions, conduct compliance reviews and investigations and initiate prosecutions. Regional offices would also have input into the development of policies and rules and would be an important source of innovation. Regional offices would play an important role in the enforcement process.

The regional offices would allow for across-the-desk contact with capital market participants, which would assist in preserving and developing industry sectoral expertise. In addition, Commissioners would travel across Canada on a regular basis and work out of the regional offices from time to time. This would enhance the policy-making process, as the Commissioners would be better informed about regional concerns.

> ... we believe that national laws and a national regulator can respond adequately to regional or local characteristics that may exist in securities markets.
>
> *Ontario Teachers' Pension Plan*
> *Toronto, Ontario*

Smaller district offices should be established where business warrants. They would function as intake offices for complaints and a base for local investigations and enforcement, and assist in the registration process for locally based intermediaries.

Adjudication

The regulatory system must have adjudicative capabilities to handle a broad range of matters, including enforcement proceedings and appeals from administrative decisions.

A fundamental question is whether, in the new structure, adjudicative functions should reside in the same body as other regulatory responsibilities. This matter has been the subject of long-standing debate.

The existing provincial regulatory authorities are multi-functional. They make policy, conduct investigations and sit as administrative tribunals. The Supreme Court of Canada has held on a number of occasions that a multi-functional agency cannot be attacked on the grounds of reasonable apprehension of bias if its structure is statutorily authorized.[4]

[4] See *Brosseau v. Alberta (Securities Commission)* [1989] 1 S.C.R. 301 and *Ocean Port Hotel Ltd. v. British Columbia (General Manager, Liquor Control & Licensing Branch)* [2001] 2 S.C.R. 781.

Proponents of a multi-functional structure argue that Commissioners can better promote the public interest by discharging several functions. In making policy, Commissioners are intimately aware of the underlying public policy objectives. They can then use that knowledge in formulating enforcement priorities and when adjudicating. The net result is thought to be a more consistent advancement of the public interest.

On the other hand, critics argue that an agency that regulates, investigates, prosecutes and adjudicates suffers from an inherent conflict of interest. Commissioners who develop policy may wish to see the policies vindicated in adjudicative proceedings, even in circumstances in which it might be unfair or improper to do so. Critics state that Canada's capital markets would be better served through a structure in which the perception of conflicts of interest did not arise. Accordingly, they call for the adjudicative function to be handled by another entity.[5]

Internationally, both the SEC and the FSA have separated the adjudicative and investigative functions to varying degrees. In the United States, administrative law judges hear SEC administrative proceedings. These judges are SEC employees and their decisions may be appealed to the SEC, where commissioners sit on adjudicative panels.[6] In contrast, the FSA's Financial Services and Markets Tribunal is wholly independent of the FSA, with its own staff and secretariat, operated and funded by a separate government department.

We have considered this matter and we believe that adjudication, traditionally housed in securities commissions, should be the responsibility of a separate body independent of the Commission.

Funding

The Commission should be an independent, self-funding organization that operates on a cost-recovery basis. Funding would be provided through fees charged to capital market participants. Fees must be reasonable and justifiable. To the extent that total fees exceeded total expenses by a specified percentage, there should be a reduction of fees the following year. Fees should be set at a level that places a fair burden on capital market participants for the costs of regulation. To the extent that some activities, such as increased enforcement efforts, have a broader public interest, it may be appropriate that they be funded in part from other federal government revenues.

There must be appropriate controls placed on self-funding agencies to ensure that their budgets stay within reasonable bounds. Accordingly, the Commission should table an annual budget and operating plan with the federal Minister of Finance, which would be reviewed by the Securities Policy Ministerial Committee. The Ministerial Committee would also review the cost-effectiveness of the Commission.

In order to minimize the potential for conflict of interest, fines and disgorgement monies paid pursuant to an order, or generated by settlement, should not be kept by the Commission.

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[5] It is important to note that commissioners who authorize investigations are statutorily prohibited from sitting on a panel adjudicating the matter in question in a number of jurisdictions.

[6] Administrative law judges are appointed by an outside government agency, however, that determines both their salary and promotion. See Phil Anisman, "The Ontario Securities Commission as Regulator: Adjudication, Fairness and Accountability" (Working Paper, October 3, 2003) at 34.

SROs

SROs such as the IDA, MFDA and the exchanges, as well as other regulatory organizations such as RS, would continue to play a critical role in regulation under the recommended model. These entities would now be subject to oversight by only one regulator. In addition to reducing SRO compliance costs, oversight by a single regulator should result in sounder regulation, as the Commission could ensure greater consistency among its policies and those of the SROs.

While the Committee believes that self-regulation is an important feature of our regulatory system that should be preserved, the Committee heard numerous complaints that there is "too much 'S' in 'SRO'". In particular, certain small investors expressed frustration with the IDA's dispute resolution process. Moreover, some commentators suggested that there be a rationalization of the number of SROs. A full review of SROs was beyond the scope of our mandate, and we therefore make no comment as to whether these concerns were justified. Undoubtedly the Commission, once formed, would want to take stock of the performance and responsibilities of the most significant SROs.

Reasons for Our Recommendation

The Canadian Securities Commission best achieves the objectives of an ideal securities regulatory structure. It preserves the strengths of the legacy structure and addresses its weaknesses in a manner that is superior to a passport system. It is consistent with the integrated, national and international scope and operation of Canadian capital markets.

Effective Enforcement. The recommended model brings a coordinated approach to enforcement, ensures resources are optimally allocated, facilitates coordination with other law enforcement agencies, permits enforcement actions to proceed on a national basis, where appropriate, and provides for uniform investor protection across Canada. A passport system does not constitute a significant improvement in enforcement.

> National regulation will provide a real benefit to small investors .... A national regulator would have the resources, clout and agility to anticipate, monitor and truly protect investors.The result will be a stronger economy, a welcoming investment environment, lower costs and administration for participants and more Canadians better able to confidently control their own financial destiny.
>
> *Small Investor Protection Association*
> *Markham, Ontario*

Policy Innovation and Development. The recommended model facilitates better and, when required, more timely policy making. Through its focus on the national interest, its role in coordinating Canada's international securities relationships, and input from the Ministerial Committee, regional and district offices and advisory panels, the Commission would benefit from broad market perspectives and developments and be positioned to make sound and innovative policy. The recommended model would provide policy development superior to that of a passport system, which requires forging a consensus among multiple regulators with differing priorities and approaches.

Cost-effectiveness. The recommended model eliminates unnecessary duplication, allows for more efficient allocation of resources, and eliminates additional compliance and opportunity costs resulting from multiple regulators. While the passport system might eliminate some additional compliance and opportunity costs, it does not eliminate duplication of resources and contemplates the continued payment of multiple fees.

Responsiveness to the Needs of Emerging Companies. The recommended model addresses the disproportionate regulatory burden the current system places on small and emerging companies by eliminating duplicative regulation. In addition, the perspectives and requirements of small and emerging companies are taken into account through advisory panels and service level standards.

> ... a single national securities regulator would raise Canada's international profile, serve as a platform to pursue international harmonization of regulation where appropriate and generally increase confidence in the quality of securities regulation in Canada.
>
> *TD Bank Financial Group*

International Perspectives. A single regulator enhances the "brand" of Canada's securities regulation internationally. It is consistent with the securities regulatory structure of every other industrialized country and allows Canada's interests to be more effectively represented internationally. The passport system does not sufficiently achieve these objectives.

Responsiveness to Local and Regional Needs. The recommended model includes a local presence through regional and district offices and benefits from regional perspectives brought by the Commissioners, Securities Policy Ministerial Committee and advisory panels. In addition, it would better draw upon sectoral expertise on a national basis than the passport system.

Stability. The recommended model applies across Canada. Jurisdictions cannot opt out, as they could under a passport system.

Equal Treatment for Investors. The recommended model provides for uniform investor protection and maximizes investment opportunities. The passport system does not provide for uniform investor protection.

Accountability and Governance. The recommended model provides for a single point of accountability to the Canadian public and capital market participants and an exemplary governance structure. The passport system does not, by itself, improve accountability or governance.

Simplicity. A single regulator structure is simple and clear, providing a single point of contact for capital market participants. It should encourage more expeditious review of capital market transactions, consistent with appropriate investor protection. The passport system would maintain Canada's complex system of 13 regulators.

Transitional Issues

New federal securities legislation, rules and policies would need to be drafted. We believe the federal government should take into account the USL and other provincial legislative reform proposals and work closely with representatives of the CSA in the drafting process.

If they choose to collaborate, the provincial governments should pass legislation that incorporates the new federal securities legislation by reference, delegates administrative powers to the Commission, dissolves their existing securities regulators and deals with other transitional issues that are discussed below. This provincial legislation would ensure a smooth and expeditious transition and provide certainty to capital market participants.

It is critical that the transition cause as little disruption as possible to capital markets activity. Accordingly, both the federal and provincial legislation leading to the creation of the Commission should come into effect on the same date, with sufficient advance notice given to capital market participants to prepare for the transition. Certain key issues that must be addressed include the following:

- Development of an organizational structure, including divisions of the Commission, staff positions and reporting responsibilities.
- To the greatest extent practicable consistent with the goal of efficiency, transfer of staff of existing regulators to the Commission's head, regional and district offices.
- Transitional arrangements at the time of implementation for matters in progress such as prospectus filings, applications, registrations, recognition orders, investigations and enforcement proceedings.

The federal Minister of Finance and provincial ministers responsible for securities regulation would handle certain of these matters. The remaining issues should be dealt with by a transition committee appointed by the Minister of Finance, which should work closely with the provincial regulators in carrying out its mandate.

> It is time for federal/provincial constitutional bickering to be moved aside.
>
> *Fidelity Investments Canada Limited*
> *Toronto, Ontario*

As the creation of the Canadian Securities Commission is a matter of national importance, the federal government should pay for all direct transitional costs.

We recommend that the federal and provincial governments promptly implement our recommendation. If, however, not all the provinces and territories decide to participate in establishing the Canadian Securities Commission, we recommend that the federal government nevertheless proceed to implement our recommended structure so that Canada would have only one securities regulator. While provincial cooperation would surely be preferable, it is not necessary. The constitutional opinions presented to the Committee confirm this conclusion.

CHAPTER seven

It's Time

It's time for Canada to have a single securities regulator. Capital markets around the world are continuing to integrate and become more competitive and important to economic growth and prosperity. Canada is now at a crossroads. Others have moved faster in adapting their regulatory structures in response to these trends. Either we can continue with a fragmented regulatory structure that has served Canada adequately in the past but that is ill suited to current realities, or we can choose to create a regulatory structure that helps Canadian capital markets become a source of comparative advantage in the increasingly competitive global marketplace.

We believe the choice is clear. Canada cannot afford to stand still. We therefore call on the federal and provincial governments to participate in the creation of the Canadian Securities Commission. Canadians are seeking increased federal-provincial cooperation in addressing important public policy priorities. Both levels of government now have an opportunity to come together and act in the national interest.

> Canadians should not settle for anything but the best they can achieve.
>
> *Canadian Bankers Association*

Other countries have already done this. In Australia, a federal state with regional diversity and shared constitutional authority over securities regulation, the federal and state governments worked together to create the ASIC, a single securities and market conduct regulator, in recognition of the fact that a single regulator was in Australia's national interest. We believe the same spirit of collaboration can, and should, animate the creation of the Canadian Securities Commission.

We believe the federal and provincial governments should implement our recommendation without delay.

There is a remarkable momentum for change, shared by capital market participants, governments and regulators. There is an unprecedented opportunity to improve Canada's securities regulatory structure.

It's time to act.

APPENDIX A

WPC Background, Terms of Reference and Composition

The MacKay Report

On November 15, 2002, Harold MacKay delivered a report to the federal Minister of Finance recommending that the Minister, working together with the provinces and territories, establish a Wise Persons' Committee to review and make recommendations to policy makers on the appropriate model for securities regulation in Canada. Mr. MacKay's report followed a month of consultations with capital market participants and other interested parties, which revealed a consensus view that the current securities regulatory system is in need of prompt and significant improvement.

Establishment of the WPC and Its Terms of Reference

In response, the Minister of Finance established the Wise Persons' Committee in March 2003 with the following Terms of Reference:

"Given:

- that a dynamic and efficient capital market in Canada will contribute to economic growth through the effective mobilization of savings and the provision of low-cost financing for new and existing businesses;
- that efficient, effective and responsive securities regulation is an important factor in ensuring a dynamic and efficient capital market;
- that securities regulation needs to provide high standards of investor protection – particularly in light of the Sarbanes-Oxley Act in response to Enron and other U.S. corporate scandals; and
- that a large number of Canadians believe that the present system of securities regulation in Canada can and should be improved,

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A Wise Persons' Committee is established. The Committee will:

1. review and assess the strengths and weaknesses of the existing system of securities regulation in Canada;
2. recommend the appropriate regulatory structure that will best meet Canada's needs; and
3. recommend a governance model and describe an accountability framework.

The objectives of the regulatory structure proposed by the Committee should be to:

- provide sound protection for investors and confidence that Canada's capital markets are regulated with the highest standards and that those standards are rigorously and equally enforced throughout the country;
- provide efficient capital markets for Canadian businesses of all sizes, and not place an undue burden on firms seeking to raise capital or on firms seeking to offer capital market services;
- encourage dynamic and innovative capital markets throughout Canada; and
- present foreign investors, governments and regulators with a positive image of securities regulation in Canada.

In carrying out this mandate, the Committee will solicit the views of governments, regulators, market participants and the Canadian public on these issues and consider any other relevant issues raised in these discussions. The Committee should, where possible, work with provincial governments and regulators and take into account the work of complementary processes aimed at improving securities regulation in Canada.

The Committee will also give particular consideration to the respective merits of two specific models against the objectives described above, namely:

(a) an enhanced version of the present system, with such practical and achievable improvements as the Committee might propose so that there is a greater sense of common purpose and more efficiency; and

(b) a single commission model in which governments electing to participate would pool some or all of their authority in a single regulator administering one set of rules.

The Committee may also consider other models, including combinations of the above.

In elaborating its recommendations, the Committee will also:

- identify any difficult or challenging issues to be encountered in achieving the model it recommends and propose ways to resolve these issues; and
- address any significant implementation issues, including transition costs, should major institutional changes be proposed.

The Committee will supervise a dedicated staff to assist in its consultations and to undertake or organize research studies or prepare papers or discussion documents it considers necessary to complete its work, subject to budgetary limits.

The Wise Persons' Committee will report by November 30, 2003".

Members of the Committee

Michael E. J. Phelps, O.C. (Chair)

Chairman of Dornoch Capital Inc., a private investment company, and former Chairman and Chief Executive Officer of Westcoast Energy Inc. Mr. Phelps holds senior positions and directorships with a number of energy companies, including serving as a member of the board of directors of Duke Energy Corporation. Mr. Phelps also serves as a director of the Canadian Imperial Bank of Commerce, Canadian Pacific Railway Company and Canfor Corporation and is Chairman of the GLOBE Foundation of Canada. Mr. Phelps is Chair of the Canada Pension Plan Investment Board Nominating Committee. He also serves on the advisory board of Aon Reed Stenhouse Inc. He is a Distinguished University Fellow and Adjunct Professor, the Sauder School of Business, the University of British Columbia. Earlier in his career, Mr. Phelps was a practicing lawyer in Manitoba and a special advisor to the Minister of Energy, Mines and Resources of Canada. Mr. Phelps was appointed an Officer of the Order of Canada in 2001. He received a law degree from the University of Manitoba in 1970 and a Master of Laws from the London School of Economics in 1971.

Harold H. MacKay, O.C., Q.C. (Vice Chair)

Senior partner in the Regina-based law firm of MacPherson Leslie & Tyerman LLP. Mr. MacKay served as the Chair of the Task Force on the Future of the Canadian Financial Services Sector from 1997 to 1998, and has advised the governments of Saskatchewan and Canada on various public policy issues, including post-secondary education and the governance of Crown corporations. He also served as Lead Director of the Bank of Canada and as Chairman and Director of the Federal Business Development Bank. Mr. MacKay is currently the Chair of the Saskatchewan Institute of Public Policy and the Clifford Clark Visiting Economist with the federal Department of Finance. He was named an Officer of the Order of Canada in November 2002. Mr. MacKay earned his law degree from Dalhousie University in 1963.

Thomas I. A. Allen, Q.C.

Senior Partner, Ogilvy Renault, Chairman of the Accounting Standards Oversight Council of Canada, and a member of the Advisory Board of the Office of the Superintendent of Financial Institutions. Mr. Allen is Chairman of Westwind Capital Corporation, parent of an independent investment dealer, and is a former Vice-Chairman of Gordon Capital Corporation. Until recently he served for many years as a public director of the Investment Dealers Association of Canada (IDA). Mr. Allen is a director of a number of public corporations. He earned a law degree from the University of Western Ontario in 1963.

Pierre Brunet, O.C., F.C.A.

Chair, Canadian Institute of Chartered Accountants. Prior to his retirement in 2001, Mr. Brunet served as President and Chief Executive Officer of National Bank Financial and as Chair of the IDA from 1984 to 1985. Mr. Brunet currently serves on the Board of Directors of a number of companies and cultural and educational organizations and was named an Officer of the Order of Canada in 1999. He is a graduate of the École des hautes études commerciales and qualified as a chartered accountant in 1964.

Wendy K. Dobson

Director, Institute for International Business, and Professor at the Rotman School of Management, University of Toronto. Dr. Dobson is the author of a number of monographs on international financial and monetary issues. She teaches economics and international business and is a member of several international policy networks. She is a director of The Toronto Dominion Bank, TransCanada Corporation and MDS Inc., and is Vice Chair of the Canadian Public Accountability Board. She has been President of the C.D. Howe Institute and Associate Deputy Minister in the federal Department of Finance in Ottawa. She holds a PhD in Economics from Princeton University.

Edwin C. Harris, Q.C.

Counsel with the Halifax office of the law firm Patterson Palmer. Mr. Harris is a member of the editorial board of the *Canadian Tax Journal*. He served as Chair of the Canadian Tax Foundation from 1992 to 1993 and was Chairman of the Accounting Research Advisory Board of the Canadian Institute of Chartered Accountants from 1986 to 1989. He has also taught corporate and tax law at Dalhousie Law School. Mr. Harris earned a commerce degree from Dalhousie University in 1954, a law degree from Dalhousie University in 1958 and a Master of Laws from Harvard University in 1959.

Michael J. Tims

Chairman, Peters & Co. Limited, a Calgary-based investment firm engaged in securities brokerage, corporate finance and mergers and acquisitions. He served as Chairman of the Canadian Investor Protection Fund from 1998 to 2000 and as Chairman of the IDA from 1995 to 1996. He is also the Past Chairman of West Island College, a bilingual private school in Calgary. Mr. Tims has previously taught finance and business policy at the University of Calgary and remains active with the university and other organizations. He graduated from the University of Calgary in 1976 and holds an MBA from Harvard University.

Professional Advisors

Elizabeth J. Harrison, Q.C.
Executive Director
(Farris, Vaughan, Wills & Murphy, Vancouver)

Clay Horner
Special Advisor
(Osler, Hoskin & Harcourt LLP, Toronto)

Candy L. Saga
Senior Advisor to the Executive Director
(Farris, Vaughan, Wills & Murphy, Vancouver)

A. Douglas Harris
Research Director
(University of Toronto Capital Markets Institute, Toronto)

Jeremy D. Fraiberg
Senior Policy Advisor
(Torys LLP, Toronto)

Gordon Boissonneault
Senior Economist
(Department of Finance, Ottawa)

Joshua L. Pekarsky
Communications Advisor
(Longview Communications Inc., Vancouver)

APPENDIX B

WPC Process

The Committee's report and recommendations are the result of a nine-month process involving extensive consultations with capital market participants (including investors, issuers, intermediaries and professional service providers), legislators and regulators, the commissioning and consideration of independent research studies, and extensive deliberations.

Consultation Paper

On May 8, 2003, Michael Phelps, the Chair of the WPC, published a consultation paper seeking input from capital market participants, legislators and regulators in the form of written submissions, requested by June 30, 2003, or in-person consultations to be held by the Committee in cities around the country. The consultation paper was published on the Committee's web site (www.wise-averties.ca) and directly forwarded to numerous parties whom the Committee felt would have an interest in the subject matter, including industry associations, institutional investors and portfolio managers, issuers, intermediaries and regulators. The Committee also published a press release and advertised the consultation dates in relevant local newspapers.

The consultation paper posed a series of questions, including:

1. What, in your view, are the key strengths and weaknesses of the current structure?
2. How well are enforcement activities related to capital markets carried out in Canada? Does the present securities regulatory structure enhance or diminish the effectiveness of enforcement? What are the key enforcement issues?
3. How does Canada's regulatory structure affect the international competitiveness of Canadian capital markets and the Canadian economy?
4. How does the current regulatory structure affect your costs of complying with securities regulation? How have recent initiatives by the Canadian Securities Administrators affected these costs? Are there other significant efficiency issues?
5. Are there unique regional and local characteristics of capital markets across Canada that affect you? What regional and local requirements are met by the current structure and how? In particular, do small and medium-sized growth companies have unique needs and how does the current regulatory structure accommodate these needs?

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6. How do you perceive the timeliness, responsiveness and flexibility of the current system in developing policies, rules and regulations and, where necessary, in revising or simplifying them to meet new circumstances?

7. What is your assessment of regulatory structures in other countries? Are there lessons to be learned from other countries' experiences?

8. What would be the best securities regulatory system for Canada?

Submissions

The Committee received a total of 92 written submissions from a broad cross-section of market participants. Submissions were received from 14 individual investors, 12 asset managers, 18 issuers (not including financial institutions), 11 financial institutions, 16 trade or industry associations, 10 law firms and 11 regulators or self-regulatory organizations.

Submissions were received from across the country and included 11 from British Columbia, 11 from Alberta, 6 from Manitoba and Saskatchewan, 36 from Ontario, 6 from Quebec, 5 from Atlantic Canada and 17 from national firms or organizations.

Copies of the submissions will be available for some time on the Committee's web site, www.wise-averties.ca.[1]

Consultations in Canada

The Committee conducted nine days of consultations across the country, including one day in each of Halifax, Winnipeg, Regina, Calgary and Vancouver and two days in each of Toronto and Montreal. The Committee met with 41 individuals or groups, including individual investors, portfolio managers, issuers, intermediaries and professional advisors. Over two thirds of the parties who attended the consultations also provided written submissions to the Committee. Members of the Committee also met with securities regulators in a number of provinces and with certain provincial ministers responsible for securities regulation.

[1] A small number of submissions were not posted on the web site at the request of the authors of those submissions.

International Consultations

In addition, members of the Committee conducted consultations in London, Brussels, New York, Boston and Washington D.C. They met with representatives of securities and financial services regulators, legislative staff, stock exchanges and other self-regulatory organizations, institutional investors and intermediaries.

Research

A priority for the Committee was to base its recommendations on a thorough analysis of the facts and issues at stake. The Committee commissioned nine independent research studies and one staff research paper, coordinated by A. Douglas Harris, the Director of Research appointed by the Committee. The studies included:

1. Gordon Boissonneault, *The Relationship between Financial Markets and Economic Growth: Implications for Canada;*
2. Joel Seligman, *The United States Federal-State Model of Securities Regulation;*
3. Karel Lannoo and Mattias Levin, *Securities Market Regulation in the EU: The Relation Between the Community and Member States;*
4. Ralph Simmonds and Ray Da Silva Rosa, *The Impact of Federalising Securities Regulation in Australia: A View from the Periphery;*
5. Poonam Puri, *Local and Regional Interests in the Debate on Optimal Securities Regulatory Structure;*
6. Douglas Cumming, Aditya Kaul and Vikas Mehrotra, *Provincial Preferences in Private Equity;*
7. Douglas Cumming, Aditya Kaul and Vikas Mehrotra, *Fragmentation and the Canadian Stock Markets;*
8. Mary Condon, *The Use of Public Interest Enforcement Orders by Securities Regulators in Canada;*
9. Charles River Associates, *Securities Enforcement in Canada: The Effect of Multiple Regulators;* and
10. Anita Anand and Peter Klein, *The Costs of Compliance in Canada's Securities Regulatory Regime.*

The research studies are published in a companion volume.

Constitutional Opinions

In order to confirm that any model for securities regulation it recommended would be constitutionally viable, the Committee commissioned three legal opinions from the following leading experts in Quebec, Ontario and British Columbia:

1. L. Yves Fortier, C.C., Q.C., Ogilvy Renault, Montreal;
2. John B. Laskin, Torys LLP, Toronto; and
3. The Honourable Allan McEachern, Fasken Martineau DuMoulin LLP, Vancouver.

The three opinions are published with the research studies in a companion volume.

Deliberations

The Committee met extensively to consider and analyze the input from market participants and the results of the research studies, and to develop its recommendations and finalize its report.

APPENDIX

List of Submitters and Consultation Participants

Advocis (The Financial Advisors Association of Canada)

AGF Management Limited

Alberta Securities Commission

Anglin Stewart Investment Group

Anina International Capital Corporation

Association for Investment Management and Research

Barclays Global Investors

BC and Yukon Chamber of Commerce

Beacon Securities Ltd.

Bennett Jones LLP

BMO Financial Group

Bourse de Montréal

British Columbia Securities Commission

Burney, D.H., CEO of CAE Inc.

Cameco Corporation

Canaccord Capital Corporation

Canada Pension Plan Investment Board

Canadian Bankers Association

Canadian Capital Markets Association

Canadian Chamber of Commerce

Canadian Council of Chief Executives

Canadian Listed Company Association

Canadian Pacific Railway

Canadian Securities Institute

Canfor Corporation

C.D. Howe Institute

Certified General Accountants Association of Canada

CIBC

Claude Resources Inc.

Cleroux, Marcel

Cosgrove, Patricia

CP Ships Limited

Desjardins Ducharme Stein Monast

Di Novo, John

Discovery Capital Corporation

Eddy & Downs

Emera Inc.

Enbridge Inc.

Encana Corporation

Fasken Martineau DuMoulin LLP

Feldman, Mark

Fidelity Investments Canada Limited

Fonds de Solidarité FTQ

Franklin Templeton Investments Corporation

George Weston Limited/Loblaw Companies Limited

Gorgendiere (de la), Marcel

Greystone Managed Investments Inc.

Grover, Warren

Hitchens, Barry

Imperial Oil Limited

Investment Counsel Association of Canada
Investment Dealers Association of Canada
The Investment Funds Institute of Canada
investorism.com
Jarislowsky Fraser Limited
Khan, Kalim
Kyle, Robert
Lambie, James
Lewtas, Amy
MacIntosh, Jeffrey
MacLellan, Robert B.
MacPherson Leslie & Tyerman LLP
Manulife Financial Corporation
Market News Publishing Inc.
Market Regulation Services Inc.
McCarthy Tétrault LLP
Newman, Steve
Nexen Inc.
Nortel Networks Corporation
Nova Chemicals Corporation
Nova Scotia Branch of the Canadian Bar Association (Securities Subsection)
Ogilvy Renault
Ontario Bar Association
Ontario Securities Commission
Ontario Teachers' Pension Plan
Osler, Hoskin & Harcourt LLP
Patterson Palmer Hunt & Murphy LLP
Phillips, Hager & North Investment Management Ltd.
Potash Corporation of Saskatchewan Inc.
Prairie Financial Inc.
Prospectors and Developers Association of Canada
Raymond James Limited
RBC Financial Group
Richardson Financial Group
Roache, J. F.
Rousseau, Marie
Saskatchewan Financial Services Commission
Schneiderman, Morris
Scotia Capital Inc.
Small Investor Protection Association
Steinhoff, Carolann
Stewart, William
Strike Minerals Inc.
Suncor Energy Inc.
Sutton Financial Group
TD Bank Financial Group
The Toronto Board of Trade
Totah, Selim
TransAlta Corporation
TransCanada Corporation
TSX Group Inc.
TWC Group of Companies Inc.
Urquhart, Diane A.
Waitzer, Edward
Winnipeg Commodity Exchange
Wisenthal, William
Wolchock, B.
Wong, Mi Ling
Yorkton Securities Inc.
Young, David